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Proposals for a Securities Market Law for Canada

Volume 3
Background Papers

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Preface

This volume contains the papers prepared by the consultants to the Securities Market Study to provide an analytical and policy background for the development of the *Proposals for a Securities Market Law for Canada* as set out in the preceding two volumes. The consultants were retained in 1973 and 1974 and detailed outlines and preliminary drafts of the papers were prepared. These drafts formed the basis of a meeting of the complete study group in November 1975 at which the basic outlines of the *Proposals* were defined. The consultants then prepared the final drafts of their papers, contemporaneously with the drafting of a preliminary version of the *Proposals*.

The final versions of the papers were submitted between September 1976 and September 1978 as they were completed. Although the footnotes to the papers have been edited to achieve a consistent form of citation throughout this volume, no attempt has been made to update the references contained in them. Thus, for example, legislative references are to the statutes and bills current when each paper was completed. The date of completion has therefore been included on the title page of each paper. The views and factual material presented are the responsibility of the authors and do not necessarily bear any endorsement of Consumer and Corporate Affairs Canada.

Although acknowledgements have been made in the general preface to the *Proposals* (Volume 1), the efforts of a number of

people mentioned there were especially important in the production of this volume. In particular, Jean R. Lajoie of the Quebec Securities Commission carefully reviewed the French translations of the papers and Mark Zigler, a recent graduate of the Faculty of Law at the University of Toronto, put the footnotes into consistent form.

October 1978

Table of Abbreviations Used in This Work

This table lists, in the left-hand column, short forms for documents, reports and books that are frequently cited in the *Proposals for a Securities Market Law for Canada*. Short forms for titles of reports appear in large and small capital letters, thus: ALI FEDERAL SECURITIES CODE; KIMBER REPORT. The short form for books is given by the author's name in large and small capitals: L. LOSS. Statutes and regulations are shown in upper and lower case Roman letters. Background papers in this volume are cited by the author's name, in italics.

Legislation

1. *Statutes*

CANADA

Alberta Securities Act	Alberta Securities Act, R.S.A. 1970, c. 333, as amended
Bank Act	Bank Act, R.S.C. 1970, c. B-1, as amended
British Columbia Securities Act	British Columbia Securities Act, S.B.C. 1967, c. 45, as amended

Canada Business Corporations Act	Canada Business Corporations Act, S.C. 1974–75, c. 33, as amended
Canada Corporations Act	Canada Corporations Act, R.S.C. 1970, c. C-32, as amended
Criminal Code	Criminal Code, R.S.C. 1970, c. C-34, as amended
Federal Court Act	Federal Court Act, R.S.C. 1970, 2d Supp., c. 10
Income Tax Act	Income Tax Act, S.C. 1970–71, c. 63, as amended
Interpretation Act	Interpretation Act, R.S.C. 1970, c. I-23
Manitoba Securities Act	Manitoba Securities Act, R.S.M. 1970, c. S50, as amended
New Brunswick Securities Act	New Brunswick Securities Frauds Prevention Act, R.S.N.B. 1973, c. S-6
Newfoundland Securities Act	Newfoundland Securities Act, R.S.N. 1970, c. 349, as amended
Northwest Territories Securities Ordinance	Northwest Territories Securities Ordinance, R.O.N.W.T. 1971, c. 17
Nova Scotia Securities Act	Nova Scotia Securities Act, R.S.N.S. 1967, c. 280, as amended
Ontario Business Corporations Act	Ontario Business Corporations Act, R.S.O. 1970, c. 53, as amended
Ontario Securities Act	Ontario Securities Act, R.S.O. 1970, c. 426, as amended
Ontario Bill 154	Bill 154, The Securities Act, 1972, Ontario, 29th Legis., 2d Sess. (First Reading, June 1, 1972)

Ontario Bill 75	Bill 75, The Securities Act, 1974, Ontario, 29th Legis., 4th Sess. (First Reading, June 7, 1974)
Ontario Bill 98	Bill 98, The Securities Act, 1975, Ontario, 29th Legis., 5th Sess. (First Reading, May 30, 1975)
Ontario Bill 20	Bill 20, The Securities Act, 1977, Ontario, 30th Legis., 4th Sess. (First Reading, April 5, 1977)
Ontario Bill 30	Bill 30, The Securities Act, 1977, Ontario, 31st Legis., 1st Sess. (First Reading, June 29, 1977)
Ontario Bill 7 (2d reading)	Bill 7, The Securities Act, 1978, Ontario, 31st Legis., 2d Sess. (Second Reading, April 6, 1978) (Reprinted for consideration by the Administration of Justice Committee)
Ontario Securities Act, 1978	Bill 7, The Securities Act, 1978, Ontario, 31st Legis., 2d Sess. (Third Reading, June 23, 1978)
Prince Edward Island Securities Act	Prince Edward Island Securities Act, R.S.P.E.I. 1974, c. S-4
Quebec Securities Act	Quebec Securities Act, R.S.Q. 1964, c. 274, as amended
Saskatchewan Securities Act	Saskatchewan Securities Act, 1967, S.S. 1967, c. 81, as amended
Telecommunications Act	Telecommunications Act, Bill C-24, 30th Parl., 3d Sess. (First Reading, January 26, 1978)
Yukon Securities Ordinance	Yukon Territories Securities Ordinance, O.Y.T. 1971, c. 1

Administrative Procedure Act	Administrative Procedure Act, 60 Stat. 237, 5 U.S.C., ss. 551–706
Investment Advisers Act of 1940,	Investment Advisers Act of 1940, 54 Stat. 847, 15 U.S.C., ss. 80b-1 – 80b-21
Investment Company Act of 1940	Investment Company Act of 1940, 54 Stat. 789, 15 U.S.C., ss. 80a-1 – 80a-52
Securities Act of 1933	Securities Act of 1933, 48 Stat. 74, 15 U.S.C., ss. 77a–77aa
Securities Exchange Act of 1934	Securities Exchange Act of 1934, 48 Stat. 881, 15 U.S.C., ss. 78a–78jj
Securities Reform Act of 1975	Securities Acts Amendments of 1975, 94 Pub. L. 29

2. *Regulations*

Alberta Securities Regulations	Alberta Securities Regulations, Alta. Reg. 80/72, as amended
British Columbia Securities Regulations	British Columbia Securities Regulations, B.C. Reg. 193/67, as amended
Canada Business Corporations Regulations	Canada Business Corporations Act Regulations, SOR 75-682, P.C. 1975-2820, Dec. 12, 1975, as amended
Canada Corporations Regulations	Canada Corporations Act Regulations, SOR 76-22, P.C. 1975-3001, Jan. 14, 1976, as amended

Manitoba Securities Regulations	Manitoba Securities Regulations, R.R. Man., Reg. S50-R1, as amended
Ontario Business Corporations Regulations	Ontario Business Corporations Regulations, R.R.O. 1970, Reg. 492/70, as amended
Ontario Securities Regulations	Ontario Securities Regulations, R.R.O. 1970, Reg. 794/70, as amended
Saskatchewan Securities Regulations	Saskatchewan Securities Regulations, Sask. Reg. 241/67, as amended

3. *Self-Regulatory*

ALI Federal Securities Code	American Law Institute, Federal Securities Code, Proposed Official Draft (March 15, 1978) (L. Loss, Reporter)
ALI Federal Securities Code, Tent. Drafts Nos. 1–6	American Law Institute, Federal Securities Code, Tentative Drafts Nos. 1–6 (1972–77) (L. Loss, Reporter)
ALI Federal Securities Code, Reporter's Revision of Tent. Drafts Nos. 1–3	American Law Institute, Federal Securities Code, Reporter's Revision of Text of Tent. Drafts Nos. 1–3 (1974) (L. Loss, Reporter)

Government Documents

1. *Reports*

CANADA

Business Corporations Proposals	R. Dickerson, J. Howard & L. Getz, Proposals for a New Business Corporations Law for Canada, vol. I, Commentary; vol. II, Draft Act (1971)

Canadian Mutual Fund Report	Report of the Canadian Committee on Mutual Funds and Investment Contracts (1969)
Kimber Report	Report of the Attorney-General's Committee on Securities Legislation in Ontario (J.R. Kimber, chairman, 1965)
Mutual Fund Proposals	J. Baillie & W. Grover, Proposals for a Mutual Fund Law for Canada (vols. 1–2, 1974) (Consumer and Corporate Affairs Canada)
Ontario Securities Commission Disclosure Report	Ontario Securities Commission, Report of the Committee of the Ontario Securities Commission on the Problems of Disclosure Raised for Investors by Business Combinations and Private Placements (1970)
Parizeau Report	Report of the Study Committee on Financial Institutions (Jacques Parizeau, chairman, Québec, 1969)
Porter Report	Report of the Royal Commission on Banking and Finance (Dana Porter, chairman, 1964)
Windfall Report	Report of the Royal Commission to Investigate Trading in the Shares of Windfall Oils and Mines Limited (Ontario, 1965)

UNITED STATES

INSTITUTIONAL INVESTOR REPORT	SECURITIES AND EXCHANGE COMMISSION, INSTITUTIONAL INVESTOR STUDY REPORT, 92nd Cong., 1st Sess., House Doc. No. 92-64 (5 vols., 1971)
SPECIAL STUDY REPORT	SECURITIES AND EXCHANGE COMMISSION, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS (parts 1–6, 1963)
WHEAT REPORT	DISCLOSURE TO INVESTORS: A RE-APPRAISAL OF FEDERAL ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS (Francis M. Wheat, commissioner, undated: 1969)

UNITED KINGDOM

RENTON REPORT	COMMITTEE APPOINTED BY THE LORD PRESIDENT OF THE COUNCIL, REPORT: THE PREPARATION OF LEGISLATION, Cmnd. 6053 (Sir David Renton, chairman, 1975)

Texts

P. ANISMAN	P. ANISMAN, TAKEOVER BID LEGISLATION IN CANADA: A COMPARATIVE ANALYSIS (1974)
K. DAVIS	K. DAVIS, ADMINISTRATIVE LAW OF THE SEVENTIES (1976)
L. GOWER	L. GOWER, THE PRINCIPLES OF MODERN COMPANY LAW (3d ed., 1969)
D. JOHNSTON	D. JOHNSTON, CANADIAN SECURITIES REGULATION (1977)

L. Loss	L. Loss, Securities Regulation (2d ed., vols. 1–3, 1961 & Supp., vols. 4–6, 1969)
J. Williamson	J. Williamson, Securities Regulation in Canada (1960)
J. Williamson, Supp.	J. Williamson, Securities Regulation in Canada, Supplement (1966)

Article

Anisman	Anisman, *Insider Trading under the Canada Business Corporations Act*, in Meredith Memorial Lectures 1975: Canada Business Corporations Act 151 (1976)

Background Papers in This Volume

Anisman & Hogg	Anisman and Hogg, *Constitutional Aspects of Federal Securities Legislation*
Cleland	Cleland, *Applications of Automation in the Canadian Securities Industry: Present and Projected*
Connelly	Connelly, *The Licensing of Securities Market Actors*
Dey & Makuch	Dey and Makuch, *Government Supervision of Self-Regulatory Organizations in the Canadian Securities Industry*
Grover & Baillie	Grover and Baillie, *Disclosure Requirements*
Hall	Hall, *Continuing Disclosure and Data Collection*

Hebenton & Gibson	Hebenton and Gibson, *International Aspects of Securities Legislation*
Honsberger	Honsberger, *Failures of Securities Dealers and Protective Devices*
Howard	Howard, *Securities Regulation: Structure and Process*
Iacobucci	Iacobucci, *The Definition of Security for Purposes of a Securities Act*
Jenkins	Jenkins, *Computer Communications Systems in Securities Markets*
Leigh	Leigh, *Securities Regulation: Problems in Relation to Sanctions*
Williamson, Capital Markets	Williamson, *Canadian Capital Markets*
Williamson, Financial Institutions	Williamson, *Canadian Financial Institutions*
Yontef	Yontef, *Insider Trading*

Canadian Capital Markets

J. Peter Williamson

June 1978

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Chapter I
Introduction

Since a nation's capital markets make possible the transfer of surplus funds from savers to those who can profitably invest in real assets – such as homes, factories, machinery, roads, or hospitals – their importance to the economy needs no explanation.

This introduction therefore begins with a discussion of the adequacy of savings in the Canadian capital market, including an examination of rates of saving, allocation of savings and investment funds among governments and private industry in Canada, and the relative importance of various sources of these funds. The role of financial institutions as suppliers of capital is considered in detail in a later paper in this volume.[1]

A. ADEQUACY OF SAVINGS

Table 1 presents some historical statistics on saving in Canada. The ratios display no particular trend, other than some increase in personal saving as a percentage of personal income. It is

The author is grateful for contributions to and critical reviews of portions of this paper by his colleague Professor Dennis Logue and by Professor Calvin C. Potter of Concordia University and wishes to acknowledge the help of his Research Assistant, Paula Eberhardt, in the preparation of this paper.

1 *See Williamson, Financial Institutions*, ch. I.

Table 1
Savings in Canada

1972-76
In millions of dollars

	Gross national product	Net national income	Personal income	Personal saving	Gross saving	Investment by non-financial private corporations
	(1)	(2)	(3)	(4)	(5)	(6)
1972	$105,234	$ 79,694	$ 83,767	$ 5,015	$23,405	
1973	123,560	94,651	97,832	7,230	29,481	
1974	147,175	113,850	117,055	9,568	38,013	$19,872
1975	165,445	130,031	136,345	12,246	40,045	17,068
1976	190,027	147,838	155,795	13,398	45,552	21,613

Savings and investment ratios

	(4)/(3)	(5)/(2)	(5)/(1)	(6)/(1)
1972	6.0%	29.4%	22.2%	
1973	7.4	31.1	23.9	
1974	8.2	33.4	25.8	13.5%
1975	9.0	30.8	24.2	10.3
1976	8.6	30.8	24.0	11.4

Source: Statistics Canada, *National Income and Expenditure Accounts*, 13-001, first quarter 1977.

always hard to compare such statistics among countries, but the savings and investment ratios in table 1 seem to be higher than those for the United States and most other industrialized countries except for Japan. Table 3 shows ratios for selected countries and table 2 shows productivity growth for those countries.

There has been a good deal of discussion in both Canada and the United States, particularly in the latter, about an impending capital shortage and the need for diversion of private consumption into investment and of government spending into business investment. Much of what has been said and predicted has been contradictory, but a rather succinct summary of conclusions was presented in the hearings before a United States congressional committee in November 1976. The summary describes conditions in the United States, but its relevance to Canada is clear.

With respect to investment, Henry C. Wallich, a member of the Board of Governors of the Federal Reserve System, said:

> "On the whole, the studies conclude that the historic shares of GNP which have been devoted to total private investment and to the sub-category of business fixed investment of about 15% and 10.5% respectively need to be raised moderately. An additional one-half to one percentage point of GNP, or about $10–20 billion a year, seems to be a reasonable number. The effort required to bring about such a change is not a minor one since in an economy working close to capacity other claims on the GNP would have to be reduced. From the point of view of the Bill, it is the share of business fixed investment in particular that needs to be borne in mind.
>
> "There are factors that raise investment requirements as well as others that reduce them. Additional requirements are called for by energy needs, environmental requirements, health and safety oriented installations, construction for the needs of a growing number of elderly persons, and general investment to make up for any shortfalls in recent years as well as possible declines in the productivity of capital. Partially offsetting these new requirements are demographic variables implying reduced construction activity."[2]

Wallich was not specific about where the extra business investment might come from. He did refer with enthusiasm to recently rising business profits and internal financing, the funding of business short-term debt into long-term debt and U.S.

2 *Investment Policy Act of 1976, Hearing on S. 3693 before the Senate Comm. on Banking, Housing and Urban Affairs*, 94th Cong., 2d Sess. 16 (1976).

Table 2
Average Annual Rate of Productivity Growth

1960–73

	Gross domestic product per employed person	Manufacturing output per man-hour
United States [a]	2.1%	3.3%
Japan	9.2	10.5
West Germany	5.4	5.8
France	5.2	6.0
Canada	2.4	4.3
Italy	5.7	6.4
United Kingdom	2.8	4.0
11 OECD countries	5.2	6.1

a. See note (a), table 3.
Source: U.S. Department of the Treasury.

Table 3
Investment as Percent of Real National Output[a]

1960–73

	Total fixed[b]	Non-residential fixed
United States	17.5%	13.6%
Japan	35.0	29.0
West Germany	25.8	20.0
France	24.5	18.2
Canada	21.8	17.4
Italy	20.5	14.4
United Kingdom	18.5	15.2
11 OECD countries	24.7	19.4

a. OECD concepts of investment and national product include non-defence government outlays for machinery and equipment in the private investment total, which require special adjustment in the U.S. national accounts for comparability. National output is defined in this U.S. Treasury department study as "gross domestic product", rather than the more familiar measure of gross national product, to conform with OECD definitions.
b. Including residential.
Source: U.S. Department of the Treasury.

legislation that has encouraged equity financing of business, including the legislation offering tax incentives to Employee Stock Ownership Plans. Sidney L. Jones, Assistant Secretary for Economic Affairs of the Department of the Treasury, added to Wallich's testimony the importance of federal government deficits. He pointed out that during the decade 1968 through 1977, the U.S. federal government had withdrawn from the capital markets $1.5 trillion, and said: "I think it's equally obvious that the balance of savings and investment Governor Wallich mentioned is made extremely difficult when fiscal policy withdraws $1-1/2 trillion in a single decade."[3]

Wallich identified as the principal sources of capital within the private sector: personal savings, corporate retention of profits, and business depreciation allowances. On forecasts of personal savings, he said:

> "The average of these savings projections is very close to the historical average of 5% of disposable personal income prevailing from 1965 to 1974. During 1976, the personal savings rate has been close to 7%. Some studies of savings behaviour have hypothesized that the savings rate may decline as the relation of assets to income recovers from the attrition that it has suffered through the inflation. It has also been hypothesized that the savings ratio has been adversely affected by more satisfactory provision for old age through social security and Medicare."[4]

With respect to corporate savings, including depreciation allowances, Wallich commented that when profits were corrected for inflation, domestic nonfinancial corporations in 1974 paid out in dividends more than they earned, so that there were no real retentions. Commenting on the longer run, he said:

> "Nevertheless, inflation-adjusted after-tax profits for domestic non-financial corporations as published by the Department of Commerce have averaged only about 2.3% of GNP in recent quarters. During the middle 1960s, when capacity was growing rapidly, they averaged about 4%."[5]

The hearings included a statement made by Jones in February 1976 before the Subcommittee on Financial Markets of the Senate Finance Committee. In that statement he commented on the relatively low level of total United States fixed investment as

3 *Id.* at 18.
4 *Id.* at 16.
5 *Id.*

Table 4
Savings and Investment in Canada

1974–76
In millions of dollars

	1974	1975	1976
Persons and unincorporated businesses			
Savings	14,632	17,516	19,484
Investment	6,009	7,700	9,418
Net lending	8,623	9,816	10,066
Non-financial private corporations			
Savings	11,906	12,550	14,391
Investment	19,872	17,068	21,613
Net lending	−7,966	−4,518	−7,222
Non-financial government enterprises			
Savings	1,295	1,053	1,453
Investment	4,417	6,699	7,176
Net lending	−3,122	−5,646	−5,723
Monetary authorities			
Savings	1	1	1
Investment	17	11	9
Net lending	−16	−10	−8
Banks and near banks			
Savings	421	678	705
Investment	227	255	310
Net lending	194	423	395
Insurance companies and pension trusts			
Savings	29	32	35
Investment	121	125	156
Net lending	−92	−93	−121
Other private financial institutions			
Savings	242	648	655
Investment	75	71	34
Net lending	167	577	621
Public financial institutions			
Savings	−46	−121	67
Investment	163	251	54
Net lending	−209	−372	13
Federal government			
Savings	2,053	−2,430	−1,608
Investment	1,029	1,232	1,331
Net lending	1,024	−3,662	−2,939

	1974	1975	1976
Provincial and local governments and hospitals			
Savings	4,354	3,017	2,592
Investment	4,843	5,966	5,774
Net lending	−489	−2,949	−3,182
Social security funds			
Savings	1,775	1,999	2,175
Investment	0	0	0
Net lending	1,775	1,999	2,175
Foreign sources			
Savings	2,052	5,274	4,733
Investment	539	495	546
Net lending	1,513	4,779	4,187
Total			
Savings	38,714	40,217	44,683
Investment	37,312	39,873	46,421
Net lending	1,402	344	−1,738
Residual error in net lending	1,402	344	−1,738

Source: Statistics Canada, *Financial Flow Accounts*, 13-002, first quarter 1977.

Table 5
Net New Issues of Securities

1972–76
In millions of dollars

	Government of Canada		Provincial bonds	Municipal bonds	Non-financial corporations	
	Bonds	Bills			Bonds	Common and preferred stock
1972	1,269	330	2,990	445	941	445
1973	−677	530	2,614	399	712	442
1974	3,272	940	3,785	553	1,210	466
1975	3,397	570	6,752	1,119	2,149	871
1976	2,588	1,645	8,980	1,240	2,258	1,050

Source: *Bank of Canada Review*, various issues, tables 28, 31, 32 and 34.

a percentage of real national output, and the relatively low productivity growth of the United States, as shown in tables 2 and 3.[6]

Savings and investment in Canada are shown in table 4 by sectors of the economy. Personal savings (including savings of unincorporated business) are very important. They accounted for 38% of gross savings in 1974, 44% in 1975 and 42% in 1976. There seems to be no evidence of a significant shift here (the ratio was 38% in 1970). Nonfinancial private corporations accounted for 53% of total investment in 1974, 43% in 1975, and 48% in 1976. Again, there seems to be no evidence of a trend away from industrial investment (the ratio was 47% in 1970).

Foreign sources of savings have become more important, rising from 5% to 13%, and then declining to 10% of total savings over the three years (foreign sources were negative in 1970).

B. NEW ISSUES OF SECURITIES

Table 5 shows for five years ending in 1976 net new securities issues of the federal government, provincial and municipal governments, and nonfinancial corporations. Aggregate new issue financing increased at a rate of about 22% a year and the shares taken by the governments and corporations remained remarkably stable. The federal government accounted for 25% of net new issues in 1972 and 1976. Municipal governments accounted for 7% in both years. Provincial governments increased their share from 46% to 47% over the five-year period while nonfinancial corporations decreased their share from 22% to 21%. At least for this five-year period, there seems to be no basis for a fear that governments are "crowding out" the private sector.

Table 4 shows evidence of a growing dependence on foreign sources of saving. This can also be seen in table 6. The federal government has in recent years (until 1978) restricted its new financing to the Canadian securities market. A substantial amount of that new financing has been in the form of Canada Savings Bonds. Provinces and municipalities, on the other hand, have turned increasingly to the United States and to the Eurobond markets. In 1976 both the provinces and municipalities raised over half of their new capital outside Canada. About 40% came from the United States and somewhat under 20% from other foreign sources. Corporations relied even more heavily on foreign sources in 1976, although they were slower to turn to these sources than were the provinces and municipalities. But in 1976 corpora-

6 *Id.* at 25, 26.

tions raised only about 30% of their new issue capital in Canada and over 40% in the Eurodollar market.

C. CORPORATE FINANCING

Table 7 provides a breakdown of net new corporate financing through the capital markets into bonds, preferred and common stock. The bulk of the financing has been in the form of bond issues, with the bond proportion remaining constant from 1972 through 1975 and then jumping in 1976.

The federal budget introduced in October 1977 proposed two income tax changes to make equity investments more attractive to individual Canadians. The first $1,000 of interest and dividend receipts had been excluded from taxable income, but capital gains had not qualified for the exemption. (One half of capital gains is included in taxable income.) Beginning in 1977, taxable capital gains have been included in the $1,000 interest and dividend deductions.

Second, the effective dividend tax credit has been increased by a combination of an increased gross-up from 33-1/3% to 50% of net dividends received, and a reduction in the credit from 4/5 to 3/4 of the gross-up. The effect of this is an increase in the tax credit amounting to 13/120 of the dividend received or 11%. Since the taxable dividend is increased by 1/6 or 16.7% the change is beneficial unless the investor's tax rate exceeds 11/16.7 or about 66%, which is beyond the highest personal income tax rate and just about at the highest combination of federal and provincial income tax.

The result should make equity financing a little more attractive, relative to debt financing. Compared to the United States, however, Canada seems already to have a tax structure favouring equity financing. The subject is discussed further in chapter III.

Table 8 compares external and internal sources of funds for nonfinancial corporations in Canada. The comparison suffers from the fact that the two sets of sources are reported in different publications of Statistics Canada, and there are bound to be some differences in the corporations included in the two sets. Internal sources can be seen to have accounted for 61% of all sources in 1974, 65% in 1975, and 57% in 1976 (the ratio was 58% in 1970).

A heavy reliance on internal sources works well when profits are high and taxation not burdensome. One forecast of savings and investment needs over future years has reached the conclusion that the share of total private fixed investment to be supplied by business savings will decline in the period after 1980, due to inadequate capital consumption allowances for replacement in-

Table 6
Canadian and Foreign Financing of Canadian Governments and Corporations: Net New Issues of Bonds

1972–76
In millions of dollars

	Government of Canada [a]			Provinces		
	Canada	Foreign		Canada	Foreign	
		U.S.	Other[b]		U.S.	Other[b]
1972	1,270	−2	0	2,119	485	362
1973	−588	−2	−88	2,087	551	−24
1974	3,317	−45	0	2,295	1,039	441
1975	3,434	−37	0	3,864	2,202	730
1976	2,590	−2	0	3,682	3,333	1,058

nicipalities			Corporations		
ada	Foreign		Canada	Foreign	
	U.S.	Other[b]		U.S.	Other[b]
	−43	115	1,551	84	−13
	−69	98	1,577	−16	−7
	128	32	1,565	227	−1
	286	193	2,300	259	374
	481	236	1,336	1,188	1,836

a. Includes Canada Savings Bonds.
b. Including Eurodollar issues.
Source: *Bank of Canada Review*, various issues, tables 29 and 30.

Table 7
Net New Corporate Financing: All Canadian Corporations

1972–76
In millions of dollars

	Bonds		Preferred	Common
1972	$1,623	72%	$199	$420
1973	1,554	72	84	527
1974	1,791	71	435	303
1975	2,932	70	743	485
1976	4,360	78	627	568

Source: *Bank of Canada Review*, various issues, table 33.

Table 8
Sources of Funds of Canadian Non-Financial Corporations

1974–76
In millions of dollars

	1974	1975	1976
External sources			
Bank loans	2,889	1,307	2,991
Other loans	569	905	720
Short-term paper	783	90	592
Mortgages	500	332	757
Bonds	1,457	2,112	2,132
Stocks	856	960	1,170
	7,054	5,706	8,362
Internal sources			
Net income	9,226	8,694	8,478
Less dividends	3,199	3,414	3,523
Retained earnings	6,027	5,280	4,955
Depreciation and depletion	5,012	5,507	6,130
	11,039	10,787	11,125
Total sources	18,093	16,493	19,487

Sources: Statistics Canada, *Financial Flow Accounts*, 13-002, first quarter 1977 and *Industrial Corporations Financial Statistics*, 61-003, first quarter 1977.

vestment and to business income taxation. As business is required to turn more heavily to external funds, financial intermediation and capital markets will become much more important.[7]

D. PRIMARY AND SECONDARY MARKETS COMPARED

Table 9 shows gross new issues of securities in Canada for governments and corporations and the volume of secondary trading in those securities. The primary market, the "new issue" market, is smaller than the secondary market particularly in equities. The latter is not surprising since equity capital is more or less permanent (some preferred issues are paid off) while debt matures and is replaced with new issues. And as we have seen, internal sources furnish the bulk of new equity to corporations.

E. CANADA IN AN INTERNATIONAL CAPITAL MARKET

For many years Canadian capital markets and financial institutions have had close linkages with markets and institutions in other countries, particularly the United States. As table 10 shows, over the past decade Canada has been a fairly consistent importer of long-term capital and a fairly consistent exporter of short-term capital. Corporations and provinces have raised substantial and rapidly growing amounts of long-term debt abroad, although until 1978 the federal government pretty much restricted its net financing to Canadian sources. (Direct investment on the other hand has been much smaller and has been declining.) The year 1970, when the Minister of Finance requested a reduction in foreign borrowing, brought a sharp decline in the total inflow of long-term funds. But by 1975 the flow was fully restored.

In 1974 there was a significant inflow of short-term capital, largely accounted for by nonbank holdings of foreign currencies abroad. These balances had been declining for some years but showed a very large increase in 1974. Apparently nonresidents have consistently moved short-term funds into Canada while residents have been moving funds out of Canada.[8]

So far as outstanding securities are concerned, recent years have seen a fairly consistent net purchase of Canadian stocks and net sales of foreign securities by Canadian residents. The pattern may be due in part to the imposition in 1971 of restrictions on ownership of foreign securities by Canadian pension funds. A

7 McCracken, *Bridging Canada's Predictable Pitfalls*, 5 PLANNING REV. 8 (1977).

8 *See* E. CLENDENNING, THE EURO-CURRENCY MARKETS AND THE INTERNATIONAL ACTIVITIES OF CANADIAN BANKS (Ottawa, Economic Council of Canada 1976).

Table 9
Primary and Secondary Markets in Canada, Excluding Obligations with a Maturity of Less Than One Year

1973–76
In millions of dollars

	Federal Government[a]		Provincial[b]		Municipal	
	Gross new issues	Secondary trading	Gross new issues	Secondary trading	Gross new issues	Secondary trading
1973	1,910		2,474		798	
1974	2,850		3,203		854	
1975	2,400	4,917	4,924	5,377	1,440	607
1976	3,950	8,339	6,334	7,130	1,450	589

Table 10
Canadian Balance of International Payments: Capital Account[a]

1966–76
In millions of dollars

	1966	1967	1968	1969
Long-term				
Net direct investment	785	566	365	350
Net new stocks	53	36	62	210
Net new corporate bonds	620	167	353	421
Net new Canada bonds	−171[a]	−75	231	−43
Net new provincial bonds	383	701	776	972
Net new municipal bonds	81	121	64	89
Net outstanding securities	−641	−477	−423	157
Other long-term	57	316	224	177
Total long-term	1,167	1,355	1,652	2,333
Total short-term	−364	−836	−1,223	−1,355

Corporate			
Debt		Equity	
Gross new issues	Secondary trading	Gross new issues	Secondary trading [c]
,053		512	9,402
,507		730	6,593
,045	4,884	1,180	5,809
,750	6,353	1,242	6,953

a. Excludes Canada Savings Bonds.
b. Excludes purchases by Canada Pension Plan.
c. Stock exchange trading.
Note: Gross new issues are those distributed by Canadian investment dealers and include some payable in foreign currency. The secondary trading shown is almost entirely in Canadian dollar issues.
Source: Investment Dealers Association of Canada.

1970	1971	1972	1973	1974	1975	1976
540	660	225	−50	−90	−20	−950
66	18	44	36	10	86	43
352	12	172	27	287	765	2,898
-131	6	−14	−98	−47	96	25
416	407	932	646	1,511	3,141	4,467
−28	−73	71	−5	143	371	649
-110	−34	491	59	−44	307	506
-363	−514	−264	−242	−734	−640	−90
742	482	1,657	373	1,036	4,106	7,548
-328	−11	−967	−858	631	455	−2,697

a. − (minus) indicates cash flow from Canada.
Sources: E. Clendenning, *The Euro-Currency Markets and the International Activities of Canadian Banks*, (Ottawa: Economic Council of Canada, 1976), pp. 78–80, for 1966–74, and *Bank of Canada Review*, for 1975–76.

government white paper issued in November 1969 announced an intention to prohibit pension plans and registered retirement savings plans from investing over 10% of their assets in foreign securities. In June 1971 the famous Bill C-259 included the change in the form of a penalty for investments beyond 10% (at cost) in foreign assets including stock or debt of foreign corporations. The legislation is contained in section 206 of the Canada Income Tax Act and the penalty is a monthly tax of 1% on the excess foreign investments.

The economics of the flow of capital into and out of Canada, including implications for economic growth, inflation, and Canadian control of the Canadian economy, are dealt with in a 1972 government publication.[9] For purposes of this paper the international capital market is simply an extension of the domestic market – an additional source of capital for Canadian users of capital and a source of investment opportunities for Canadian investors.

The principal foreign market for Canadian securities, both of corporations and governments, has for many years been the United States. In recent years, however, Canadian issuers have looked to other foreign markets, particularly the German market. The Eurobond market has become increasingly valuable to Canadian bond issuers,[10] as can be seen in table 11. It is a truly international market. Offerings are not aimed at investors in any particular country. London is probably the most convenient place from which to launch a Eurobond offering but the purchasers will be located around the world. As table 11 indicates, the United States dollar is the most popular denomination for Eurobonds, with Canadian dollars and deutschemarks the next most popular. Most Canadian issuers that have used this market have denominated their bonds in Canadian or United States dollars but the City of Montréal has made substantial deutschemark bond offerings.

The Eurobond market has opened up a substantial source of long-term capital to Canadian corporations and governments. The options now facing a Canadian issuer include the Canadian securities market, the United States securities market, private placements in either country, perhaps private or public offerings in another foreign country, but more likely a Eurobond offering in any one of three currencies. The choice is likely to depend on interest rates in different markets and for different currencies, the maturities that are feasible (in the Eurobond market there is still some reluctance on the part of investors to accept maturities

9 Government of Canada, Foreign Direct Investment in Canada (Ottawa 1972).

10 St-Pierre, *Eurobonds Strong Magnet for Canadians*, 84 Canadian Banker 23 (January-February 1977).

Table 11
Eurobond Issues by Currency of Denomination

1963–76
In millions of U.S. dollars

	Total	U.S. dollar		Deutschemark		Canadian dollar		Others[a]	
1963	$ 164	$ 102	62.2%					$ 62	37.8%
1964	719	485	67.5	$ 200	27.8%			34	4.7
1965	1,041	726	69.7	203	19.5			112	10.8
1966	1,142	921	80.6	147	12.9			74	6.5
1967	2,002	1,780	88.9	171	8.5			51	2.5
1968	3,573	2,554	71.5	914	25.6			105	2.9
1969	3,156	1,723	54.6	1,338	42.4			95	3.0
1970	2,966	1,775	59.8	688	23.2			503	17.0
1971	3,642	2,221	61.0	786	21.6			635	17.4
1972	6,366	3,908	61.4	1,160	18.2			1,298	20.4
1973	4,193	2,447	58.4	1,025	24.4			721	17.2
1974	2,134	996	46.7	344	16.2	$ 60	2.8%	734	34.4
1975	8,567	3,738	43.6	2,278	26.6	558	6.5	1,993	23.3
1976[b]	10,763	6,656	61.8	2,012	18.7	1,239	11.5	856	8.0
Total	50,428	30,032	59.6	11,266	22.3	1,857	3.7	7,273	14.4

a. Includes the Dutch guilder, the French franc and composites such as EUA, EMU and EURCO.
b. First nine months.
Source: Morgan Guaranty Trust Company of New York, *World Financial Markets.*

Table 12
Characteristics of the Eurobond Market

1975–76
In millions of U.S. dollars

	Issue volume (annual rate)	Size of issue		Final maturity[a] (number of years)		Yield[b]	
		Average	Largest individual	Average	Longest	Average	Lowest
1975							
Third quarter	$3,700	$31.1	$100	5.5	10	9.43%	9.00%
Fourth quarter	4,200	33.0	100	6.6	10	9.45	9.00
1976							
First quarter	10,300	47.9	300	6.9	12	8.98	8.32
Second quarter	9,000	49.5	500[c]	8.1	15	9.05	8.35
Third quarter	7,600	40.5	300	9.3	15	8.73	8.25
Fourth quarter	9,900	43.4	125	8.4	15	8.53	7.75

a. Excludes convertible issues.
b. Excludes convertible issues and floating rate notes.
c. Private placement.
Source: International Monetary Fund, *IMF Survey*, vol. 6, April 4, 1977.

as long as those that are customary in North America), and size of issue. Table 12, from the International Monetary Fund, shows some of the parameters for Eurobond offerings.

The international nature of a Eurobond offering may permit a rather low level of disclosure. Avoidance of the prospectus requirements of regulatory commissions in the United States, Britain and Canada is a usual feature. Offering circulars giving basic financial information are common, but so far as disclosure is concerned the Eurobond market seems to be substantially free of regulation.

Whether the Eurobond market is a net addition to the financing capacity of Canadian issuers depends, of course, on the extent to which Canadian investors purchase Eurobonds. There do not seem to be any statistics on Canadian investment in Eurobonds, but it seems unlikely that Canadians buy Eurobonds in anything like the volume in which they sell them. The principal reason for tapping the Eurobond market is to finance at a lower interest cost than would be required in Canada. So there is little reason to expect Canadian investors to purchase Eurobonds at lower interest rates than they could obtain at home.

F. WEAKNESSES IN THE CANADIAN MARKETS

A study undertaken in 1972 by a Canadian government working group found four gaps and weaknesses in the Canadian capital markets: there was a lack of (1) venture capital for new and small firms, (2) expansion capital for small and medium-sized Canadian-controlled firms, (3) large pools of capital for major resource exploitation and other capital-intensive projects under Canadian control, and (4) capital for general development in regions of slow economic growth. Coupled with this statement was a claim that lenders generally tend to give preference to foreign controlled firms, probably because of their generally greater size and credit-worthiness. [11]

The study attributed the gaps and weaknesses not necessarily to any lack of investment capital but to inadequacies of the marketplace itself. Specifically, the study said, "the shortage of entrepreneurship in the financial industry frustrates the kind of industrial intermediation – the drawing together of financing and all the many other components to bring a new enterprise into being – which could permit a larger proportion of major projects to be undertaken in Canada by Canadians". [12] The report commented

11 FOREIGN DIRECT INVESTMENT IN CANADA, *supra* note 9, at 92-93.
12 *Id.* at 93.

that merchant banking and venture capital services were not sufficiently developed in Canada to channel adequate funds to new ventures,[13] and concluded that while Canada does need foreign capital, it would need less if the quality of its own capital markets were improved.

Commenting on the attractiveness of Canadian capital markets to institutions, the study observed that pension funds and mutual funds complained of the absence of liability trading by Canadian brokers (a topic dealt with in some detail in chapter II of this paper). The institutions also complained of high brokerage costs in Canada, compared to those in the United States.[14]

On the securities industry itself, the study commented that the capitalization of the industry was not great and that this must inevitably affect its ability to assume risk and to engage in entrepreneurial activity. The study said, "the point here is not that the Canadian industry is necessarily reacting in more conservative fashion to a particular risk, but that the risk itself is perceived differently because of much smaller capitalization".[15] Underwriting activity was singled out as lacking the benefits of competition. The study said, "indeed, the absence of vigorous competition within the securities industry, and from other parts of the financial sector, is such that most securities firms feel little need to protect their position by aggressively taking on new kinds of financing challenges. Also, the competitive environment probably has adverse implications for the price that users have to pay in raising money, which, in turn, affects their competitiveness".[16]

The study observed that there is no indication that Canadians are less willing to make risky investments than are Americans, reinforcing the conclusion that what the capital market needs is better financial institutions to channel savings into new and medium-sized enterprises.[17]

Some of the devices used by the federal government to influence the allocation of capital within Canada are referred to in the study. Tax policy, methods of deficit financing, transfer payments to provinces and individuals and the pattern of federal government expenditures are examples. The direct role of the government through public financial institutions can be seen in Central

13 *Id.* at 97.

14 *Id.* at 98. This topic is discussed at length in ch. III of *Williamson, Financial Institutions.*

15 Foreign Direct Investment in Canada, *supra* note 9, at 99. Capitalization of securities firms is discussed in ch. II of *Williamson, Financial Institutions.*

16 Foreign Direct Investment in Canada, *supra* note 9, at 101.

17 *Id.* at 103.

Mortgage and Housing Corporation, the Industrial Development Bank and the Canada Development Corporation.[18]

Some might argue that this study exaggerated deficiencies in the Canadian capital markets, and that in any case there has been improvement since 1972. An unpublished paper prepared within the federal Department of Finance in 1973 reviewed the financial problems of small and medium-sized businesses in Canada, the United States and Britain, and commented that the markets in all three countries had been criticized for failing to meet the needs of this part of the economy. All three countries had struggled with the problem and Canada seemed to have done as much as the other two. The paper went further to argue that there was neither a shortage of capital for small business, nor a lack of financial intermediaries, but rather a lack of viable investment opportunities. Studies of small business failures repeatedly identify poor management and lack of experience as major causes of failure, and the failure rate of businesses that have achieved the goal of a first public financing is high.

G. CONCLUSIONS AND POLICY IMPLICATIONS

Statistics through 1976 do not suggest any deficiencies in saving or adverse trends in saving. At the same time Canada, like the United States and the United Kingdom, has been experiencing rather lower growth in productivity than have Japan, France, Italy and West Germany. Japan has experienced phenomenal growth, backed by an extraordinary rate of savings. But Canadian savings rates are not much behind those of any of the other countries.

There seem to be widespread fears of future trends toward reduced saving, particularly if government transfer payments grow and less is left of individuals' and corporations' investible surpluses. Both the Canadian and U.S. governments seem to be aware of the danger. In recent years the share of new financing going to corporations has held up well.

There is some evidence of a growing dependence by corporations on debt, rather than equity. But the balance between internal and external sources has not changed much in recent years. Once again there are fears, primarily related to government policies, that internal sources may be forced to play a reduced role in the future. But current changes in the tax laws at least favour equity financing.

Foreign capital is becoming increasingly important to the

18 *Id.* at 108.

Canadian economy, and the Eurobond market must be regarded as a significant supplement to the Canadian capital market. Keeping Canada attractive to foreign investors is therefore increasingly important.

Criticism has been directed at the functioning of the Canadian capital markets chiefly in terms of the way they serve small and medium-sized industrial corporations. The same criticism can be found in the U.S. and the U.K. There is a good deal of anecdotal evidence and widespread opinion, though little statistical evidence, to support this. One cannot dismiss complaints about malfunctioning and anticompetitive features of the market, even though they are unsupported by clear evidence.[19] But there is reason to believe that the difficulties in creating and maintaining a lively small business community within the economy are more closely related to management ability than to the availability of financing.

Chapter II
Efficiency of the Canadian Capital Markets

For those concerned with public policy, a critical question is: "How well are the capital markets working?" The answer from economists generally comes in the form of an assessment of "efficiency". But there are many kinds of efficiency as the term is applied to capital markets. Some of them are appropriate to the public policy question and some are not. Much that has been offered in testimony on the state of the capital and securities markets refers to "efficiency", without making clear what kind of efficiency is meant, and indeed the efficiency meant is often of a kind not particularly relevant to the public policy issue at hand.

A. THE MEANING OF EFFICIENCY

The term "efficient market" is used in at least three senses. The kind of efficiency that is most important in terms of the national economy is so-called "allocational" efficiency. A market that is efficient in this sense allocates capital to users (business, government and individuals) in such a way that those who can make the best use of capital are taken care of first and those who make the poorest use of capital are the last to receive it. This sort of efficiency ensures that savings are channeled into the most

19 The complaints reinforce some of the observations in another paper. *See Williamson, Financial Institutions*, ch. II.

productive uses, and maximum economic benefits accrue to the nation as a whole.

1. *Allocational Efficiency*

One has to be a little careful about the criteria used in judging allocational efficiency. To the economist, "most productive" usually means most profitable to the saver. So if two business opportunities exist, one in rural Nova Scotia offering a rate of return of 6% and one in urban Ontario offering a return of 10%, allocational efficiency is served if the Ontario opportunity is chosen first by those with savings, and the Nova Scotia opportunity attracts no funds until the more profitable venture is fully financed. Most economic analysis would go at least one step further, however, and add a risk dimension to the two opportunities. Risk here refers to the uncertainty surrounding the expected rates of return. If the 6% return is much safer than the 10% return, then the Nova Scotia opportunity may be as attractive to savers as the Ontario opportunity, perhaps even more attractive. There is a problem in defining and measuring the risk in an investment opportunity and we will look more closely at risk measures later.

A refined criterion for allocational efficiency, then, is the ability of one opportunity to attract the funds of savers before a second opportunity that offers a lower "risk adjusted" return or a poorer "risk-return combination".

One who is concerned with the public policy issue may object that what is most profitable to an individual (or corporate) saver is not necessarily what is best for the nation. Relative unemployment between rural Nova Scotia and urban Ontario may seem to call for more investment in the former location, even though it offers a lower return and a poorer risk-return combination. There are two answers to this. One is the Adam Smith argument that in a free economy the risk-return criterion is sufficient and if there are unemployed in rural Nova Scotia where investment is unprofitable they should move to urban Ontario. The second answer is that if a government wishes to channel investment into high unemployment areas it should shift the risk-return prospects by way of tax relief or subsidies or perhaps even tax penalties, so that the risk-return criterion allocates savings in a way that satisfies national interests by also satisfying individual interests.

It is easy to see both approaches at work in the Canadian mixed economy. Investment is allowed, by and large, to go its own way in seeking the most attractive opportunities. But taxes and subsidies of one sort or another are frequently applied so as to

make the activities most favoured by a government also those most attractive to an investor.

In this context, then, an economist's conclusion that efficient allocation has been achieved is gratifying to the public policy-maker. It says that savers are responding to the taxes and subsidies efficiently, that they are selecting the opportunities that (giving effect to taxes and subsidies) are most attractive in risk-return terms. But it does not confirm that the taxes and subsidies themselves are correct. They may or may not be encouraging what is good for the country and discouraging what is bad.

2. *Operational Efficiency*

A second kind of efficiency necessary to the first is so-called "operational" efficiency. A market that is efficient in the operational sense is one with low transaction costs. It is a market in which investors can easily transfer their investments from one user of capital to another as in selling shares of one corporation and buying those of another, or from one type of investment to another as in selling shares and buying bonds. The greater this operational efficiency, the greater the assurance that allocational efficiency will actually be achieved. Operational efficiency is sometimes thought of as being limited to brokers' commissions or dealers' spreads. But "transaction costs" really go beyond this to embrace the costs of obtaining information about investment opportunities and processing this information and indeed the costs of a regulatory "investor protection" system that may, in shielding investors from unsuitable ventures, make it difficult for them to find suitable ones.

3. *External Efficiency*

The kind of efficiency that is most often analyzed by economists, and on which the most substantial literature exists, is neither operational nor allocational. Indeed it generally carries no identifying adjective – a source of some confusion. One author has suggested that it be termed "external" efficiency because it has to do with the activities of "outsiders" – investors and savers who are not brokers or dealers or otherwise "inside" the market.[20] "Inside" efficiency on the other hand is what has been described above as operational efficiency.

External efficiency has to do with information and prices. A

20 West, *On the Difference between Internal and External Market Efficiency*, 31 Fin. Analysts J. 30 (November-December 1975).

market in which prices fully reflect available information is externally efficient. The term "fully reflect" means that good and bad news about a company is incorporated in the price of the company's stock as soon as the information is disseminated. Publication of an unexpected item of good news brings about an immediate upward adjustment of the price. There is no advantage to be gained in buying the stock after the news is out. Such a market is sometimes referred to as "fair" in that an investor can be confident that the stock prices he faces fully reflect all that is publicly known about the companies and no investor can trade profitably through the use of public information.

Even though the prices in an externally efficient market fully reflect available information they are not necessarily "correct" in the sense of accurately representing the true value of a company. To some extent the future of a company is simply unknowable without clairvoyance and even in an efficient market the price of a stock is based on only what investors know. And to some extent what is known about a company is known only to insiders and is not publicly available. There is a version of external efficiency – so-called "strong form" efficiency – that describes a market as one in which prices fully reflect even inside information. But evidence of this extreme form of external efficiency is uncertain and there is plenty of evidence that possessors of inside information have been able to use it to advantage.

For a market to be externally efficient, information must be freely available. The cheaper the information and the more easily obtained, the greater the number of investors who will analyze it to reach a new price judgment, and the faster prices will adjust. But it may not take a great many knowledgeable investors to bring prices to levels that fully reflect the information they have. So external efficiency may be attainable with a far from perfect flow of information.

The important point is that the existence of external efficiency in a marketplace has often been passed off as proof that the marketplace is allocationally efficient. External efficiency is *necessary* to allocational efficiency but it is not synonymous with allocational efficiency. For the latter we need both external and operational efficiency. Unless this requirement is kept clearly in mind – and in many analyses it is not – we are apt either to overlook the matter of operational efficiency or to assume that because a market is externally efficient it must be operationally efficient.

B. REQUIREMENTS FOR ALLOCATIONAL EFFICIENCY

Allocational efficiency, the efficiency we really care about, demands both external efficiency and operational efficiency. Without external efficiency prices do not fully reflect available information. It is bad enough that the capital markets present us with surprises we cannot possibly anticipate. But if prices do not even reflect what we do know, then they clearly fail to reflect the most likely returns and risks in the companies whose securities are traded.

Operational efficiency is important to allocational efficiency for two reasons. First, a generally high level of transaction costs makes investment generally less profitable and hence discourages all investment although it does not necessarily distort prices of securities relative to one another. Second, uneven and substantial transaction costs will distort prices. If the commission cost of buying stocks is much greater than the cost of buying guaranteed savings certificates, then stocks are that much less attractive than certificates.

The allocational efficiency in which we are most interested is the efficiency in the primary capital market – the market in which individuals, businesses and governments raise funds to invest in real assets, like houses, machinery and roads. But primary capital markets are much smaller than secondary markets (as we saw in chapter I) and most of the efficiency that is tested and measured is the efficiency of secondary markets. How is this efficiency relevant to the allocation of resources to real assets? The answer lies chiefly in the pricing function of the secondary markets. The price of a company's stock on the Toronto Stock Exchange reflects what investors expect from the company in the way of earnings and dividends and the rate of return they expect on their investment in the stock. The rate of return expected will depend on the risk or uncertainty that investors perceive in the stock and it is this rate that constitutes the company's "cost of equity capital". This rate cannot be observed directly but it can be deduced, at least approximately, from the quoted stock price. The cost of equity capital is important because it serves as a criterion for investment decisions by the company itself. So long as the company can find investments in real assets that offer a rate of return above that cost, it will pay to issue more stock and invest the proceeds.

The device that allocates investment in real assets is cost of capital. Investments will – or at least should – be made only if the promised return is greater than the cost of the funds invested. And the cost is deduced from the price of stock (and other securi-

ties) in the securities market. If this market is allocationally efficient and prices fully reflect what is known of company prospects, then those prices are a good guide to each company's cost of capital and will lead to an efficient set of investments in real, productive assets.

This pricing function is the chief link between secondary markets and investment in real assets. But there is at least one other link. In a good secondary market cheap transactions and "fair" prices inspire confidence and make it easy for a saver to invest, alter his portfolio to suit changing needs and opportunities, and withdraw funds as needed for other purposes. Thus they will tend to bring down the cost of capital for all corporations, and encourage investment in real assets.

C. TESTS OF EXTERNAL EFFICIENCY

A substantial amount of research has been done on the efficiency of capital and securities markets. Most of it has to do with external efficiency - whether the market is a "fair game" for investors.

One area of research has been concerned with serial correlation of stock prices. If there are patterns over time in the movement of stock prices, then one might expect to be able to take advantage of these patterns to make money. It turns out that there are often such patterns but that the ordinary investor cannot take advantage of them because they involve very small price changes and commission costs more than wipe out the profits.[21] These results confirm external efficiency but offer no reassurance about internal efficiency. There is some evidence that patterns in price movement may in fact be *caused* by transaction costs, even though the costs prevent investors from taking advantage of the patterns.[22]

Another area of research concerns direct observation of the impact of news on stock prices. A well-known study on stock-splits[23] and a study of the effects of major world events[24] both concluded that the United States market was externally efficient.

A third focus of research, in both the United States and Canada, has been on the ability of professional managers to "beat

21 *See* R. BREALEY, AN INTRODUCTION TO RISK AND RETURN FROM COMMON STOCKS (1969).

22 *See* Smidt, *A New Look at the Random Walk Hypothesis*, 3 J. FIN. & QUANTITATIVE ANALYSIS 235 (September 1968).

23 Fama, Fisher, Jensen & Roll, *The Adjustment of Stock Prices to New Information*, 10 INT'L ECON. REV. 1 (February 1969).

24 Reilly & Drzycimcki, *Tests of Stock Market Efficiency Following Major Events*, 1 J. BUS. RESEARCH 57 (summer 1973).

the market" – to achieve risk-adjusted rates of return above those obtainable by simply "buying the market" or assembling portfolios by random selection.[25] Once again, the conclusions have generally been that markets are externally efficient, that professionals have not succeeded, after paying transaction costs, in outperforming the market itself.

Finally, a fourth series of tests has been directed to the risk-return character of the securities markets. According to the theory we have already seen, in an externally efficient market securities should be priced such that expected returns accompany high expected risks. And assuming investors hold diversified portfolios, expected returns should be proportional to expected market risk, as opposed to diversifiable risk, or total risk. (This point is discussed later. Briefly, since diversifiable risk can be eliminated by combining stocks in a diversified portfolio, there is no reason to demand, or expect, a compensatory rate of return.) The results of these tests have not been conclusive. By and large, it appears that in United States markets expected returns are proportional to expected risk but often to total risk rather than market risk.[26] This relationship casts some doubt on the external efficiency of these markets.

The research described above was almost all carried out using data from securities markets in the United States. There are a few research findings based on Canadian data.[27] Two studies were concerned with the impact of institutional trading – whether the transactions of institutions seem to distort stock prices. These studies are discussed elsewhere in the context of individual and institutional trading.[28] Briefly, one study found little or no "price pressure" effect,[29] while the other found that mutual fund transactions did have an impact.[30] This impact suggests some lack of external efficiency.

A third study is particularly interesting, because it examined separately two classes of stocks listed on the Toronto Stock Ex-

25 *E.g.* Jensen, *The Performance of Mutual Funds in the Period 1945–1964*, 23 J. Fin. 389 (May 1968); Williamson, *Performance of Canadian Mutual Funds, 1961–70*, 36 Bus. Q. 94 (autumn 1971).

26 A number of research findings on this point are described and discussed in Studies in the Theory of Capital Markets, pt. II (M. Jensen ed. 1972).

27 A summary of the research can be found in Saint-Pierre, *L'efficience des marchés financiers secondaires au Canada*, 2 L'actualité Économique 232 (avril-juin 1976).

28 *See, Williamson, Financial Institutions*, ch. V.

29 Close, *Price Reaction to Large Transactions in the Canadian Equity Markets*, 31 Fin. Analysts J. 50 (November-December 1975).

30 J. Evans, Mutual Fund Trading and the Efficiency of Canadian Equity Markets (Working Paper No. 214, Faculty of Commerce and Business Administration, University of British Columbia, 1975).

change: industrials, and mining and oil stocks.[31] Data for 450 industrials, 110 mining and 40 oil stocks over the period 1948–66 were used. For the total of all three groups, rate of return appeared to *decline* with increasing risk – an indication of external inefficiency. For the industrials alone (and for almost all classes of industrials examined separately) rate of return increased with risk – a sign of external efficiency. But for the mining and oil stocks, rate of return declined with increasing risk, and the market for those stocks was apparently inefficient.

The mining and oil stocks, then, present an interesting case. The author of the study suggested some explanations for the results.[32] Investors in mining and oil stocks may realize that on average these stocks do not offer a fair return for the risk taken but hope for extraordinary profits on a "long shot". That is, these investors may regard mining and oil stocks as equivalent to lottery tickets. A second possibility is that investors are simply much too optimistic – chronically optimistic – about mining and oil stocks. The study quoted evidence that many of these investors do regard mining and oil stock purchases as gambling, and tend to be poorly informed.[33] The mining and oil stock market may or may not be serving the preferences of those who buy these stocks, but in conventional terms the market appeared to be externally inefficient.

A fourth study, of eighty-seven stocks listed on the Toronto Stock Exchange, covered the 1959–71 period and reached a conclusion similar to the one reported above for all stocks – rates of return declined as risk increased and the market was apparently externally inefficient.[34] However, there was no separate testing of industrial and mining and oil stocks.

Overall, the Canadian listed market for industrials seems to be very similar to the United States market in terms of external efficiency, and the level of efficiency is high. There is some evidence that institutional trading in Canada introduces more distortion in prices than does institutional trading in the United States, but there is also evidence to the contrary. The market for mines and oils, however, appears to be different and operates at a low level of external efficiency.

31 J. Boeckh, Long-Run Stock Market Performance in Canada: Implications for Allocational Efficiency (1968) (Ph.D. dissertation, University of Pennsylvania).

32 *Id.* at 110-12.

33 *Id.* at 135-36.

34 Findley & Danan, *A Free Lunch on the Toronto Stock Exchange*, 6 J. Bus. Admin. 31 (spring 1975).

D. OPERATIONAL EFFICIENCY IN THE SECONDARY MARKET

Few investors will find it attractive to seek out directly purchasers of stocks they wish to sell or sellers of stocks they wish to buy. It will almost certainly be more practical to make use of the services of a broker or dealer. During the later years of fixed commissions on stock exchanges in the United States, the so-called "fourth market" evolved, a market in which institutions deal directly with one another, without the intervention of a broker or dealer. But even the fourth market relied and still does rely (despite unfixed commission rates some 300 to 400 institutions still use the fourth market) on agents, or information intermediaries, who provide a searching service. The best known is Instinet, an automated system linking subscriber institutions.

1. *Brokers and Dealers*

Payment of a commission to a broker secures the services of an agent who will search for the "other side" to a transaction. The commission is one part of the transaction cost. If the market is thin, with few buyers and sellers bringing in orders at any particular time, then even with the services of a broker it may be difficult to obtain a "fair" price. A buyer may pay more, or a seller receive less, than the "equilibrium price" which is the price that the most eager buyer will pay and the most eager seller will accept in a market with plenty of buyers and sellers. The deviation from the equilibrium price is another element of transaction cost.

There is an alternative to reliance on the presence of other public buyers and sellers in the market. One can turn to a dealer, a member of the securities industry who stands ready to buy or sell a stock. In this case the cost (perhaps in addition to a commission) is the dealer's bid-ask "spread".

2. *Auction and Negotiated Markets*

An auction is a kind of sale organized so that the seller receives the highest price any buyer attending the sale is willing to pay. A securities auction market adds a second feature: a buyer obtains the lowest price any seller is willing to accept. And a "continuous auction" market is one in which both characteristics are always present for all listed securities. The alternative to an auction market is a negotiated market, in which buyer and seller agree on a price independently of what other buyers and sellers may be willing to pay or accept.

3. *Exchange and Over-the-Counter Markets*

Both auction and negotiated markets are compatible with securities firms acting as either brokers or dealers. The stock exchanges in Canada and the United States maintain continuous auction markets. These markets have traditionally also been broker, rather than dealer, markets. Customers have brought their buy and sell orders to brokers, either "limit" orders calling for execution only at a price set by the customer, or "market" orders calling for the broker to use his best skill and judgment in completing the execution at a favourable price. In either case the broker serves as a commission agent, representing the customer but neither buying from the customer nor selling to him.

In the United States there is a very substantial over-the-counter market in stocks not listed on an exchange. This market is regulated to some extent by the National Association of Securities Dealers, a self-regulatory organization. In recent years the association has developed a quotation system, NASDAQ, for about 2,400 stocks, providing price quotes as do the stock exchange quotation systems.

Canada has virtually no over-the-counter market in stocks and the same has been true of the United Kingdom. But recently, a small over-the-counter market has been developing in the United Kingdom, apparently fostered by investment bankers arranging placements to institutions and then to the public. The financial editor of *The Times* reported in August 1977 that the London Stock Exchange was caught between a wish to make it easier for members to deal in unlisted companies and a concern for retaining the regulatory powers that go with a full listing. The editor's suggestion was the development of a new market with a modified form of listing agreement.[35]

The stock exchanges, particularly the Toronto Stock Exchange and the New York Stock Exchange, have for many years extolled the virtues of the broker-auction market. The auction market has clear advantages. But the attractions of a broker market are not as clear.

For the investor who is willing to trade only at a specific price, who is seeking to buy or sell a small number of shares and is in no hurry to complete a transaction, the pure broker market probably works well enough. A limit order can be left with a broker until another broker appears with a customer willing to buy or sell at the limit price. For the investor who is in a hurry, however – whether

35 The Times (London), August 2, 1977, at 14, col. 2.

because he needs cash or has cash to invest and will find a delay costly in terms of having to borrow or to hold idle cash, or whether because he expects the stock to rise or fall in value and wishes to act before the change – the broker market may not be satisfactory. There may simply be too long a delay before another customer appears to take the other side and complete the transaction. The larger the trade, the greater the likelihood that this will happen. One way to speed up the process, of course, is to reward the broker, to provide an incentive for him to seek out a customer on the other side. This is just what many institutions in the United States do today – they pay premium commissions to brokers who place large blocks. Another way to achieve a quick transaction is to place a "market" order, expressing a willingness to trade with whoever offers the best price, whatever that price may be. But even a generously paid broker may be unable to find a party to complete a limit order transaction and in a thin market – one with few willing buyers and sellers – a market order may be completed at a quite unsatisfactory price.

In a dealer market the investor buys from or sells to a dealer and the quality of the market depends on the readiness of dealers to quote bids and offers with a narrow spread between them. There are those who argue that an all-dealer market is best. It is interesting that in North America the first stock exchange – the forerunner to the New York Exchange – was organized for the trading of government bonds. But bond trading, except for very small transactions, long ago moved from the exchange to a dealer market. The same is true of foreign exchange trading in Europe. At least one commentator has predicted that an international market in equities will be a dealer market.[36] And many U.S. brokers are expressing a conviction that the future of the Wall Street brokers' institutional business lies in a dealer market.[37]

4. *The Third Market in the United States*

In the United States an exchange market and an over-the-counter market exist side by side for a substantial number of stocks. The so-called "third market" is an over-the-counter market in New York listed stocks. The market is an informal one with no particular structure, made up of firms that are not members of the New York exchange. Some are well capitalized – better capitalized than New York Stock Exchange specialists. In recent years

36 Yassukovich, *L'organisation et le développement du marché hors bourse des euro-obligations*, in L'Avenir des marchés de valeurs mobilières, Journées d'études 1976 (Institut universitaire international, Luxembourg 1976).

37 *See e.g.* Securities Week (New York), January 31, 1977, at 2a.

the third market has succeeded in attracting about 7% of all trading in listed stocks and this share has persisted following the unfixing of exchange commission rates.

The New York exchange has done its best to arrange the demise of the third market. In 1974 the Securities Subcommittee of the Senate Committee on Banking, Housing, and Urban Affairs reported Bill S. 2579, abolishing fixed commission rates on the exchanges. The New York exchange, in the course of the hearings on this legislation, proposed a requirement that trading in listed stocks be permitted only on the exchanges – in other words, that the third market be legislated out of existence. This proposal found its way into Bill S. 3126 which would have authorized the SEC to impose such a requirement, and in the course of hearings on the bill in 1974, the role of the third market was discussed in detail.

The New York Stock Exchange position was that elimination of fixed commission rates would remove the primary incentive for firms to belong to the exchange. These firms would leave, taking their business to the third market and the central auction market would wither away to the great loss of the investing public. The answer put forward to this argument was that if the exchange is truly an efficient marketplace then it could survive competition with other markets.

T. Lawrence Jones, president of the American Insurance Association, testified before the Senate Securities Subcommittee on the function of the third market and its importance to members of the association. He said:

> "The continued ability of third market dealers to handle institutional orders with the same degree of efficiency and flexibility which they now possess is important to the members of our Association.
>
> "Third market firms are one of the few sources of competition with the specialist system on the New York Stock Exchange (NYSE) for making markets in common stock. Together with member firms which position blocks of stock, third market dealers enable institutions to trade in a manner least likely to disrupt the marketplace.
>
> "As financial institutions have grown, and as individuals have increasingly chosen to invest through professional managers, the specialist system for making orderly markets in common stock has not changed. Large dealer firms have developed the practice of negotiating trades off the exchange floor to meet this need. If the dealer regularly quotes a two-sided market in a security, he is called a market maker. Dealers which are members of the New York Stock Exchange, and which negotiate trades

'upstairs', or off the exchange floor, are required by exchange procedures to take a completed trade to the floor in order to 'cross' it for execution with the specialist which holds a monopoly to make markets for particular stocks on the floor.

"If the dealer not only negotiates the transaction off the floor, but also executes it without participation of an exchange specialist, he is said to operate on a 'third market' for listed stocks.

"Although the member dealer and the third market dealer operate in the same way, and compete for some of the same business, when the member dealer executes on the exchange floor, procedures require the exchange community to collect two commissions from customers on the transaction – one from the buyer and one from the seller. If the dealer finds both sides of the transaction it gets two commissions. If not, another firm receives the second commission. In addition to those commissions, the specialist may earn three separate fees when participating in the transaction. If the specialist supplies part of the passive side of a transaction in his capability as a dealer, he receives a dealer's commission to the extent of his participation.

"The specialist may also receive two types of floor brokerage apart from the dealer's fee. The first is paid if any limit orders on his book participate in the block transaction. The SEC's *Institutional Investor Study* found that limit orders usually receive the benefit of any block discount or premium. In some situations, the *Study* said they do not. The *Study* also observed that stop orders received disadvantageous executions at times. The second type of floor brokerage is paid to the specialist in a block transaction by a dealer even though the dealer is represented at the post on the floor. In some cases, the *Study* reported such 'writeouts' were earned by the specialist in return for his role as a 'finder' in the block transaction. In specific instances, however, the *Study* concluded these 'writeouts' raise regulatory questions, 'particularly with respect to the independence of at least some specialists' administration of the retail market'.

"I have outlined the commissions and floor brokerage required by exchange rules at some length because the fact they apply to member dealers and not to third market dealers is the basic distinction, and, perhaps the only qualitative distinction between these two types of firms,

both of which are so important to institutional investors. When we hear some spokesmen in the securities industry call for restrictions upon third market dealers, what we suspect they are really saying is that all dealers should be subject to the Exchange's requirements on fixed dealer commissions and floor brokerage fees.

"The suggestion that all trading in listed stocks should be required to take place on an exchange is usually based on the fear that including third market dealers in a composite quotation system will eliminate the auction market on at least one side of each trade. There is serious question, however, of the extent to which trades are presently 'auctioned' on the exchanges themselves. This subcommittee's study found the percentage of trading on the New York Stock Exchange where a firm acted as dealer on one side of the trade increased from 28.8% in 1945 to 45.1% in 1971. Inclusion of third market dealers with member firm dealers would not significantly affect this degree of dealer participation at present. Trading in the third market now equals approximately 7% of the total NYSE volume."[38]

On the matter of choice of markets, he said:

"The decision whether to take an order to a member firm dealer or to a third market dealer is necessarily a subjective one. Each trade has certain variables, and the dealer likely to offer best execution in a particular situation will receive the order.

"Third market firms during the past four years have annually received approximately 10% of the total common stock transactions from our members. Approximately the same amount has been executed through affiliated brokers on regional exchanges. Our members use on the average ten different third market firms.

"The traders in our companies say third market firms are quite competitive with member firms in executing institutional orders which do not require a dealer to take a very large position in the stock. Larger transactions may require the capital which a few member firms are capable of committing.

"During 1973 there has been a noticeable decline in trading by our companies in all markets due to the general

38 *SEC Authority over Third Market Trading: Hearings before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 93d Cong., 2d Sess. 59 (1974).

economic conditions. Third market firms appear to have felt this as much, if not more, than member firms. One of our companies, for example, reports its percentage of trades in the third market has declined from 9.2% in 1970 to 4.7% in 1973. Trading through affiliated broker dealers appears to have decreased along the same lines."[39]

The subcommittee came to the conclusion that competition among markets and brokerage firms is beneficial and that a central market system should preserve the benefits of that competition. The Treasury was even more specific in urging strengthened competition among market-makers.[40]

5. *New York Stock Exchange Specialists*

In the third market, or any over-the-counter market, "market-making" consists of standing ready to buy from the public or sell to the public in reasonable quantity and at a reasonable spread between bid and offer prices. The New York Stock Exchange, despite its commitment to a broker market, found over 100 years ago that customers in an exclusively broker market could not always count on completing a transaction quickly at a satisfactory price. The answer was a market-maker on the floor of the exchange: the specialist. The specialist brings together buyers and sellers and receives a commission for this. But more important, he also acts as a dealer, buying for his own account from customers who wish to sell and selling to customers who wish to buy always at a price close to the "going" price. He is supposed to provide an assurance, then, that no customer will suffer the disadvantages of a "thin" market. For this activity the specialist is compensated by what he can make in the difference between the prices at which he buys and those at which he sells. The "spread" he quotes between his buying price and his selling price has a lot to do with the profitability of his dealing.

The specialist is something of an anomaly on the New York Stock Exchange, an exception to a broker auction market. He is a necessary exception, and one the exchange points to with pride. Yet the specialist's role has been subject to some highly critical reviews.

The SEC *Special Study* said of the specialist system in 1963 that "it appears to be an essential mechanism for maintaining continuous auction markets and, in broad terms, appears to be

39 *Id.* at 60-61.
40 *Id.* at 36.

serving its purposes satisfactorily".[41] But this conclusion was accompanied by a number of recommendations for changes in policies and procedures. Conflicts of interest were seen as a serious problem; there was evidence of excessive trading by specialists; some firms contributed more to the quality of the market than did others, and the quality varied from stock to stock, with most specialist activity taking place in stocks already enjoying a high volume rather than in those that were thinly traded. The New York Stock Exchange methods for evaluating quality of specialist trading were criticized; ability and willingness to position blocks varied among specialists and there seemed to be a need for greater specialist capital. Perhaps the most significant conclusion was that the capacity of specialists to provide price stability was quite limited at best, but that specialists should be able to provide depth, probably more than they were providing.

Some eight years later, the *Institutional Investor Report* once again found substantial differences in quality among specialists, and complained that the New York Stock Exchange did not provide the appropriate incentives.[42]

The specialist has a privileged position. He has until recently been given a monopoly to deal in a particular stock or group of stocks on the floor of the exchange. He alone has knowledge of the "book", the list of buy and sell "limit" orders that have been left with him. He carries a responsibility: to service market orders promptly at a "fair" price and so prevent an imbalance of buy and sell orders from distorting the price. And he suffers from one disadvantage: he is not permitted to solicit others, to look for buyers when he is confronted with many sell orders and must buy for his own account, and to look for sellers when he is confronted with buyers.

There are arguments that the monopoly is unnecessary, that competing specialists would serve the market better, that the "book" should be open for all to see, and that the specialist should be free to solicit others. These arguments are discussed elsewhere in connection with proposals for a new national market system, but what is more important in the present context is whether the specialist concept is appropriate – a dealer in the midst of a broker market. In the United States there seems to be little question. The specialist dealer function is needed.[43] Indeed, the specialist alone

41 Securities and Exchange Commission, 2 Report of Special Study of Securities Markets 167 (1963).

42 4 Institutional Investor Report at 1958-59.

43 In testimony before the SEC in August 1977 the chairman of the New York Stock Exchange said that public-to-public transactions - handled by brokers representing public customers, without the intervention of a dealer - accounted for 57% of 1976 reported volume on the New York Stock Exchange; *see* NYSE, Statement of

has proved inadequate to meet the needs of institutional traders with large blocks to buy and sell. For the most part, specialists are not well enough capitalized to deal in institution-size blocks. Probably more important, they do not deal directly with an institutional clientele, so they cannot arrange large placements. As a result the exchanges in the United States have had to go a further step, to permit members other than specialists to deal as principals in large blocks. Moves away from the traditional broker market, however, have met strenuous resistance from member firms.

6. *Competition, and Superiority of Agent or Dealer*

In a 1976 article,[44] Hamilton reported that empirical testing of spreads in New York listed stocks and over-the-counter stocks indicated that specialists do not enjoy economies of scale, and thus contradicted a principal argument in favour of reserving monopolies for specialists. He also concluded that wholesale spreads on listed stocks would have been greater if the stocks had been traded over-the-counter[45] and hence that the exchange need not fear competition from a dealer market.

In 1976 competition between specialists returned but the reasons for it have been the subject of a bitter dispute. In June 1976 the specialist firm Kingsley Boye & Southwood began wide promotion of a discount public brokerage business. In October a rival specialist firm, Robb Peck McCooey & Company, was established, some say in retaliation against Kingsley Boye. The rival firm succeeded in drawing away a large portion of Kingsley Boye's traditional limit-order business. The SEC has expressed its approval of this single example of specialist competition, but with some reservations because of the possibly anti-competitive purpose underlying the rivalry.[46]

In December 1976, Richard Zecher and Susan Phillips, of the SEC Directorate of Economic and Policy Research, proposed to the

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the New York Stock Exchange, Inc., before the SEC Hearings on Off-Board Trading Rules 4 (August 2, 1977).

44 Hamilton, *Competition, Scale Economies and Transaction Cost in the Stock Market*, 11 J. Fin. & Quantitative Analysis 779 (December 1976).

45 *Id.* at 795. A Morgan Stanley & Co. study in mid-1977 confirmed these results.

46 SEC, Securities Exchange Act of 1934 Release No. 13662, June 23, 1977, CCH Fed. Sec. L. Rep. (extra edition No. 700). At one time specialists did compete. In 1933 there were 203 specialist units on the New York Stock Exchange and 466 stocks had competing specialists. Over the years the number of units had declined to 109 by 1967, and no stock issue had competing specialist units at that time, although specialists do compete on other exchanges; Securities Industry Study, Report of the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs, 93 Cong., 1st Sess. 126-27 (1973).

commission a study of auction and dealer markets as a preliminary to the development of a National Market System. The proposal pointed out that much of the debate concerning the development of this system had been based on the assumption that auction and dealer markets were inconsistent and that agency-auction markets are superior to dealer markets.[47] The SEC itself, in its statements, had generally repeated this assumption.

The proposal suggested that it would be appropriate to reconsider the superiority of agency-auction markets over dealer markets. Rather extensive reasons were given, reviewing the effects of competitive commission rates, the mechanization of the over-the-counter market, the growing institutionalization of the market, increased market-making competition, and improved electronic communication.

Figure 1 shows a spectrum from pure agency-auction market to pure dealer market. The coexistence of marketplaces ranging from pure agency-auction to pure dealer suggests that it is incorrect to assume that either kind of market is inherently superior to the other.

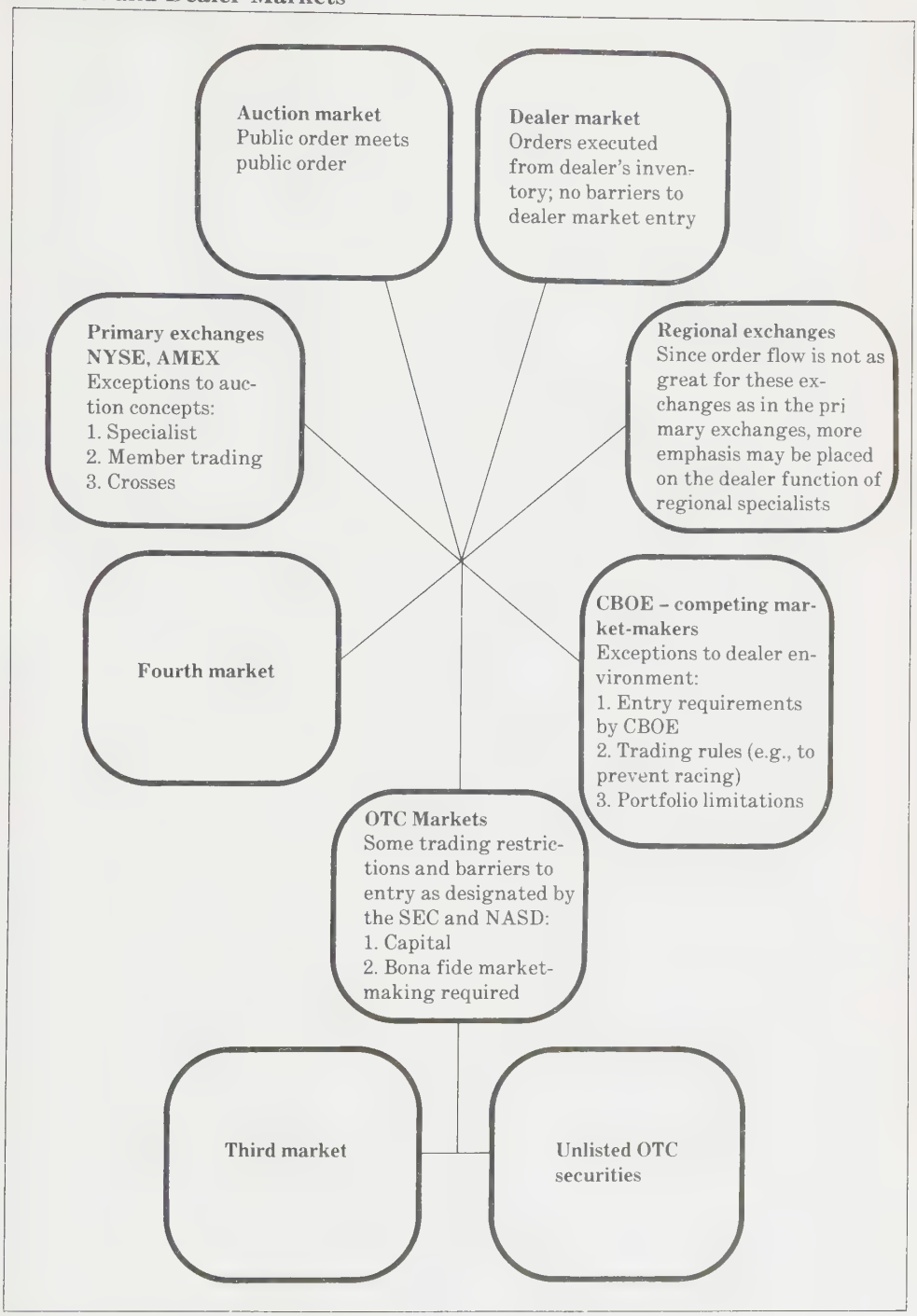
7. *The Toronto Stock Exchange and Liability Trading*

The Toronto Stock Exchange, like the New York exchange, has always defended the value of a broker market. Toronto has been much more resistant than New York to principal transactions by member firms, which are known variously as "principal transactions", "block trading", or "liability trading". In the course of the Ontario Securities Commission deliberations in 1976 on the matter of fixed commission rates in Ontario, a number of submissions expressed apprehension about preserving liquidity and meeting the demands of institutional traders. But none of the submissions to the commission showed any willingness to see liability trading provide the needed liquidity.[48] Virtually all indicated a profound distrust, and some saw liability trading as a probable but unfortunate consequence of abandoning fixed commission rates. The broker market was seen as clearly superior to a dealer market and at least one submission commented that the TSE registered trader system works better than the NYSE spe-

47 R. Zecher & S. Phillips, Information Memorandum to the [Securities and Exchange] Commission: Re Studies Related to the National Market System (December 15, 1976).

48 The same attitude on the part of the securities firms was reported in D. Shaw & R. Archibald, 7 The Management of Change in the Canadian Securities Industry 31-32 (1972) (The Securities Firm in the Canadian Capital Market). Part of the

Figure 1
Auction and Dealer Markets



Source: *See* note 47 *supra*.

cialist system. No reference was made to the work of West and Tinic,[49] who had found the agent-dominated TSE market to compare unfavourably with the specialist-dealer-dominated NYSE market.

West and Tinic distinguished three marketplaces in terms of broker and dealer functions. The dealer-specialist on the New York exchange, as described above, carries an *obligation* to participate as dealer in order to achieve depth and price continuity. In the over-the-counter market, which is negligible in Canada so far as stocks are concerned but substantial in the United States, there are as yet no obligations imposed on participants. Any broker-dealer can deal and make markets in OTC stocks without being held to standards of depth or price continuity (except that quotes must be real ones, backed up by a willingness to buy or sell).

On the Toronto Stock Exchange there are "registered traders" who have a role similar in some respects to that of the New York specialist, at least in principle. The registered trader position was created by the TSE in 1962 and was modified significantly in 1966. Prior to that time members were free to trade for their own accounts on the floor of the exchange, whether for "investment" purposes or simply to take advantage of short-term price swings, perhaps resulting from short-term imbalances between supply and demand. At the same time, members had no obligation to take positions.

To anyone familiar with the specialist system on the New York Stock Exchange, the principal disadvantage of the TSE system before 1966 might have appeared to be the absence of obligatory market-making. However, to some observers of the TSE, an even more significant shortcoming was the opportunity for floor traders to take advantage of public orders handled by other members. The TSE market was then, and still is, thin enough that a substantial order to buy or sell can have a price impact large enough to provide an incentive for a floor trader to make use of knowledge or suspicion of an impending order to buy or sell in anticipation of the order and then to fill the order himself.

In 1966 the TSE decided to formalize "professional" floor trading. Members were invited to apply for the status of "registered traders" for their floor representatives. In order to provide them with a privileged position, the previous freedom of all floor brokers to trade for their own accounts was reduced through

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reason for a distaste for liability trading may stem from a lack of necessary capital and a reluctance to furnish or obtain it; *id.* at 58, 61.

49 Tinic & West, *Marketability of Common Stocks in Canada and the USA: A Comparison of Agent Versus Dealer Dominated Markets*, 29 J. FIN. 729 (June 1974).

procedural formalities including time-stamping of orders that makes short-term trading highly inconvenient. Floor brokers were also prohibited from financial participation in a floor-managed account, while registered traders were left free of these formalities. And in return for the privileges, the registered traders were obligated to engage in a certain amount of market-making and to refrain from "destabilizing" transactions.

In 1973 the rules were modified and, at the end of 1978, the position of the registered trader was roughly as follows.[50] A registered trader must apply to the TSE for his position and he is assigned "stocks of responsibility". (There are about one hundred registered traders with from five to eighty stocks each and almost all the listed stocks have been assigned.) His privileges and obligations relate to those stocks. He is privileged through an exemption from a rule requiring that every order executed on the floor must be time-stamped in a member office before execution. He is also partially exempt from the short-sale up tick rule, to the extent necessary to meet his responsibilities. The registered trader carries a responsibility to maintain a market quotation (for at least one board lot) no wider than a specified spread (which is subject to negotiation with exchange officials for each stock) and to provide odd-lot bids and offers within stipulated premiums and discounts. He is also required to "trade in a stabilizing manner against the trend" and he has a general responsibility to see that "registered trader and other nonclient trades do not interfere with the reasonable execution" of a customer order, when he is aware of that order. This last condition responds to the charge of taking advantage of public orders, referred to above, in the pre-1966 system. The condition is seen by some as a crucial element in the registered trader position.

The stabilizing requirement is spelled out more specifically. The registered trader's transactions in his "stocks of responsibility" are to be "predominantly of a market stabilizing nature". Stabilizing trades are purchases below the last preceding trade at a different price (or sales above the last preceding at a different price). He is prohibited from destabilizing trades on other stocks while establishing or increasing a position. Destabilizing purchases are those at prices above the last preceding trade at a different price.

Clearly the responsibilities focus on price stability rather than on providing market depth. (The conclusions of the SEC *Special Study* in the United States, referred to above, were to the effect

50 *See* TSE by-laws, ss. 8.26-8.30, 11.15, 11.16 and 16.04, 3 CCH Can. Sec. L. Rep. ¶¶ 89-340 to 89-344, 89-405, 89-406 and 89-624.

that at least on the NYSE this same relative emphasis had been wrong.) Like the specialist, the registered trader is intended to serve customers with small orders, not institutions with a need to trade large blocks.

Some 10% to 12% of TSE dollar volume consists of trading by registered traders. A small part of this represents odd-lot business.

Members of the Toronto exchange other than registered traders are discouraged from dealing in listed stocks. The following description is taken from a Toronto Stock Exchange Notice to Members of late 1975.

"BACKGROUND REASONING

"The Canadian market in listed equities has developed primarily as an agency market. Dealer trading plays a less significant role in the Canadian listed market than in other markets. Both in the United States and the U.K. markets, the dealer function is represented on the floor, in the one case by floor specialists and in the other by jobbers. Neither of these roles are formally represented on the floors of Canadian stock exchanges. In addition, in the U.S. considerable dealer trading in the form of "block positioning" has developed both by exchange members and by third market dealers. In Canada, the bond market is basically a dealer market with the majority of trades being done on a positioning basis.

"The use of broker's capital can add liquidity to the marketplace. The use of such capital can assist both with *bridging the time factor* necessary to locate buyers or sellers on the other side and also with *smoothing out the supply and demand factor* to the benefit of clients. Thus, while Canadian exchanges prefer that the marketplace be primarily an agency market they feel dealer trading with customers should be facilitated where it can improve the agency market. The question the exchanges have faced in devising appropriate rules is the extent to which such trading should be permitted and under what terms and conditions.

"The rules regulating dealer trading with customers have varied from time to time. At one time such trades could be made *off* the floor in amounts as low as $25,000. In 1959 the level moved to $50,000 and in 1962 the figure was fixed at $100,000. A major change was made in the rules in 1968 when a rule package was adopted which raised the size of trades permissible for trading off-floor between members and their customers.

"The new package which was adopted by all Exchanges in 1968 included a new volume discount rate and the five-day accumulation period. Under the accumulation principle, an order executed over a period of five days got the benefit of the volume discount as if it had been completed in one day. The prime reason for the adoption of these provisions was to create more liquidity in the Canadian listed market. With these provisions it was decided that the size of trades which could be done on a dealer basis should be increased which would cause more trades to come to the floor to be filled in the auction market. The rules continued to provide, however, that very large trades could be made *off* the floor of the Exchange and therefore could bypass orders existing on the floor of the Exchange, which orders are frequently orders of individual investors.

"Provisions were made for two types of off-floor trades. One was termed an 'internal secondary distribution'. Such distributions were in the minimum amount of $500,000 and done by making distribution of shares internally to the members' own clients at a price related to the prevailing markets. No part of such trades had to involve other members or their clients.

"The second was termed an 'external secondary distribution'. They could be made in amounts of not less than $250,000. In these trades, a portion of the trade, normally 20%, had to be offered to other members for their clients at the same price at which the stock was being offered to the clients of the broker who had taken on the position. These offerings were made by opening a book on the floor of the Exchange one half-hour prior to the opening of trading.

"A third form of dealer trade, commonly referred to as the 'tag end rule' was adopted in 1971. Under it, a member was permitted to deal with his customer on the floor in order to take on the remainder of an order after the agency market had been exhausted. Such on-floor trades were permitted to clear up 'tag ends' of orders with an original value in excess of $400,000.

"This last provision, which had been made extremely restrictive, was adopted after much discussion and consideration. It was agreed that the rule was to be carefully monitored to test its effectiveness. Since its adoption only six on-floor tag end trades have taken place. It appears

that the rule is too complicated and it has not provided the additional liquidity which had been expected of it."[51]

This statement accompanied a new set of rules which retained $400,000 as the minimum order size for a principal transaction but established two forms for these transactions: on-floor and off-floor. An on-floor transaction would have to meet other orders on the floor; an off-floor transaction would normally involve the sale of a block by a member firm to at least twenty-five purchasers and once again orders on the floor would have to be met with stock supplied at the distribution price to all investors with buy orders on the floor at this or a higher price.

In early 1976 the Market Functions Committee of the Toronto Stock Exchange recommended a reduction in the $400,000 minimum. Specifically, the committee recommended that the minimum for each stock be 10% of the number of shares traded in the stock in the preceding calendar year and at least $50,000 in value. In all cases an order of $300,000 would qualify. The exchange did make some changes in the procedures for principal transactions but did not change the $400,000 minimum size.

The Notice to Members said:

> "In considering the procedure for principal transactions on the floor it is necessary to bear in mind that the rules have been created to permit the use of dealer capital in the context of an agency-auction market. Those trying to make trades under these rules will find a number of provisions which will make block trading on a principal basis less simple than it would be if such rules to safeguard the agency-auction market were not included. However, as has often been said by the Exchange, for the benefit of all participants in the secondary trading markets, it is necessary to support and maintain an effective agency-auction market. These regulations will be more readily understood if this overriding consideration is kept in mind."[52]

It is quite clear from the paragraph above that there were still strong misgivings about the use of principal transactions and a persistent conviction that a broker-auction market is best.

Another serious concern had to do with the fixed minimum commission structure on the Toronto Stock Exchange, and a fear that member firms might circumvent the minimum rates for

51 TSE, Notice to Members No. 1264 (October 1975). The description quoted accompanied the statement of new rules governing off-floor principal transactions by members.

52 TSE, Notice to Members No. 1385 (October 21, 1976).

institutional trading through block positioning. Hence these comments in the same notice:

> "(a) Commission Equivalent Requirements:
>
> "In agreeing to take on a contra position to complete an order, a member must bear in mind that if, when the position is unwound, he has not obtained a trading profit equal to or greater than the commission equivalent requirement he may be criticized by the Exchange for overly aggressive pricing. In Take-On Trades this consideration will be important in deciding on both the actual net price at which the member is willing to deal and on the Recorded Price (see below).
>
> "NOTE: the average spread or profit resulting from take-on and/or unwinding of positions involving principal transactions is to be not less than the amount which would have been earned by the member if the transaction(s) had been accomplished as agent. Note, however, that the average spread or profit can only be measured after the position is unwound – it cannot be measured in relation to the Recorded Price."[52a]

The Market Functions Committee of the Toronto Stock Exchange reported that in 1976 there were sixty-five principal transactions done on the exchange and that the aggregate "required commission equivalent" was $263,000.[53] But the aggregate profit actually obtained on profitable trades was $547,000 and the aggregate losses on the eleven trades where the member failed to obtain the requisite commission equivalent was $162,000. The net profit was then $385,000 or nearly 50% more than what the rules required. The committee said that 83% (fifty-four out of sixty-five) of the trades should be considered successful.

Of the 1.7 million shares involved in these principal transactions, $959,000 (56%) were unwound on the floor to other members, $619,000 (36%) were unwound by crosses on the floor and $128,000 (8%) were unwound on U.S. exchanges, or through other trading outside Canada, through redemptions or conversions. The committee concluded that principal transactions had not led to weakening of the minimum commission structure and believed that the number of shares unwound on the floor indicated that they materially contributed to floor liquidity.

In 1977 the pressure for increased liability trading was renewed. Early in the year the Market Functions Committee recom-

52a *Id.*

53 *Memo* from chairman, TSE Market Functions Committee (March 17, 1977), accompanying TSE, Notice to Members No. 1450 (March 23, 1977).

Table 13
Percentage of Agency Trading by TSE members in Interlisted Canadian Companies Executed on U.S. Markets

May 1975–October 1976

May 1975	November 1975	March 1976	June 1976	September 1976	October 1976
6.94%	10.77%	12.93%	12.87%	15.34%	13.63%

Source: Toronto Stock Exchange, Market Functions Committee.

mended lowering the minimum $400,000 to $100,000.[54] The reason had to do with an alarming shift of trading from Toronto to United States markets.

The committee's findings are summarized in table 13.

Further analysis of the division of trading by TSE members between Toronto and U.S. markets indicated that a substantial percentage of the larger orders were going to the United States. This shift was particularly true for orders in the $100,000 to $200,000 range. The committee suggested four reasons. Clients were in some cases insisting that they benefit from negotiable commission rates in the United States; anonymity is more easily guarded in the United States market; principal transactions are permitted in the United States regardless of order size; and as trading has shifted to the United States market that market has become more liquid and a "better" market than the Canadian market.

The committee urged strongly that unless the $400,000 minimum was lowered an increasing portion of large order business could be expected to move to U.S. markets. This would reflect both an increasing number of Canadian brokers carrying business to those markets and also Canadian institutions short-circuiting Canadian dealers and going directly to American dealers. The committee said that experience with the $400,000 minimum had indicated that principal transactions had been constructive and beneficial to the market. They had not resulted in commission cutting or "dealerization" of the market. The committee also noted that a reduction of the $400,000 minimum to $100,000 would not by itself halt the shift of trading to the United States but it would help.[55]

The change was approved by the TSE board of governors in March, and by the membership (voting fifty-seven to thirty-three) in April 1977. (The Montreal Stock Exchange decided to maintain the $400,000 level.) The Ontario Securities Commission completed the process by granting its approval in June in conjunction with its approval of a new commission rate structure.[56] Objections were made to the commission emphasizing the risk, particularly to firms with small capital, and arguing that increased liability trading would threaten the fixed commission rates and lead ultimately to negotiated rates. But perhaps the major reason for objecting was a fear on the part of small firms of increased competition from the heavily capitalized firms.

In its submission to the Ontario Securities Commission, the

54 *Id.*

55 *Id.*

56 *In re* Securities Act and by-law 153 of the Toronto Stock Exchange, [1977] OSC Bull. 171-75 (July).

TSE discussed, of course, the slippage of business to the United States. The statistics in table 13 were extended to show that the percentage of trading on U.S. markets was 12.47% in November and 16.40% in December 1976 and 13.70% in January 1977.[57] But generally improved liquidity was also held out as a major objective of the change. There was perhaps some basis for complaints that the exchange had seized on the slippage problem as an excuse for dealing with liquidity. Some members argued that slippage was due more to commission rates than to a lack of liability trading and one letter to the commission claimed that there had been no significant slippage in liability trading itself.[58]

The background memorandum furnished by the exchange to the commission provided a detailed history of principal trading in TSE stocks, with the minimum transaction raised in stages from $25,000 in 1958 to $500,000 in 1968. Until 1971, principal trades were all "off-floor" and reporting was delayed. The so-called "tag end rule" introduced in 1971 an on-floor combination of agency and dealer transaction with better disclosure.

The memorandum also drew the important distinction between an "auction" and an "agency" market, pointing out that an auction market need not be an agency or broker market.

The change from $400,000 to $100,000 as the minimum transaction for principal trading was a significant one. In September 1976, according to the exchange's *Revenue and Market Analysis Study*, nearly 60% of member agency business for institutions was in orders above $100,000 and nearly 40% was in orders between $100,000 and $400,000.[59]

8. *Analysis of Spreads - The Price of Marketability*

The West and Tinic study concluded that the "price of marketability services is higher in the TSE than in either the NYSE or OTC (U.S. over-the-counter) market".[60] Demsetz did the original work in this area. In his article in 1968 he used the bid-ask spread

57 TSE, Background Memorandum concerning Principal Transactions 31 (May 23, 1977).

58 Letter from Maison Placements Canada Inc. to the Ontario Securities Commission (June 10, 1977). The letter also made the point that there was substantial business done in the United States in transactions over $500,000, for which commissions were negotiable in Canada as well as in the United States. The exchange memorandum, however, argued that "the percentage of volume actually consummated by the member as principal masks the importance of the *availability* of the service.... What is generally known to institutional accounts is that a dealer going to a U.S. exchange can give the account a clean-up price on orders of any size"; TSE, Background Memorandum, *supra* note 57, at 31.

59 TSE, Background Memorandum, *supra* note 57, at 32.

60 Tinic & West, *supra* note 49, at 729.

as the "cost" to an investor of having his order handled without any delay. The investor is guaranteed that his transaction will be executed instantly at either the bid or ask quoted by the specialist. The lower the cost of immediate execution the better the market from the point of view of the investor. Demsetz found that this cost was proportional to the stock price and inversely proportional to the volume of trading, while it did not seem to matter in how many markets the stock was traded.[61]

West and Tinic used the Demsetz analysis as a starting point,[62] adding to Demsetz's relationship a measure of price volatility and one of trading continuity. For 200 stocks on the TSE over the period December 1–13, 1971, the continuity and the number of markets was not significant but, just as in Demsetz's case, the spread was proportional to price and inversely proportional to volume. It was also proportional to price volatility.[63]

The same regression analysis was performed for the NYSE and over-the-counter market and then a modified form of the

61 Demsetz, *The Cost of Transacting*, 82 Q. J. Econ. 33 (February 1968).

Demsetz ran regressions, explaining the bid-ask spread in dollars per share (S) by the number of recorded transactions in a stock per day on the New York Stock Exchange (T), the price per share (P), and the number of markets on which the stock was listed (M). Demsetz used data for 200 stocks chosen at random from those listed on the New York Stock Exchange. His observations were for two days (January 5 and February 28, 1965) and his data on spread, price and transaction frequency were calculated from the Fitch sheets. The equation that is of most interest is:

$S = .2102 + .008996P - .003589T - .04712M.$

Demsetz reported that the coefficient for M was not significant, so he was left with a conclusion that the spread was proportional to the stock price and inversely proportional to its volume of trading.

62 Another interesting analysis, contemporary with Demsetz' work, was performed by Arthur D. Little Inc. (ADL) for the American Stock Exchange, in October 1968. This study used as the measure of market quality the average change in price of a stock on successive trades. This change is essentially a measure of price continuity; the lower the change the greater the continuity and the higher the quality of the market. The extent to which the continuity changes with the size of an order measures the depth of the market and the ADL study examined the effect of going from one to five round lots.

ADL used a sample of transactions for 20 trading days, June 18 to July 23, 1968. A total of about 720,000 transactions involving about 1,000 issues on each day were represented in the data. The regression equation that was deduced is:

The average change in successive trades, expressed as a percent of the security price,

$= 1.782 - .055P + .000655P^2 - .302 \log T + .00042N,$

where P is the price of the stock in dollars per share, T is the volume in transactions per issue per day, and N is the number of shares of stock per transaction.

The equation indicates that doubling volume decreases the expected price change by about .07% to .09%. Increasing the size of transaction between 1 and 5 round lots increases the expected price change between trades by .04% per round lot.

63 The regression equation was:

$Spread = 2.16 + .039P - .3457 \ln V + .41563 \Delta P$

where P is price, V is average number of shares traded per day and ΔP is price volatility.

analysis was performed to identify differences among these markets. The TSE compared unfavourably with both the NYSE and the over-the-counter market. TSE spreads were higher than those on the other two markets for the same price level, the same volume, and the same volatility.

The overall conclusion was that:

> "the average bid-ask spread in the TSE is larger than its counterpart in the NYSE, even after adjustments are made for the differential effects of price per share, trading activity and price volatility. Put somewhat differently, this result indicates that the marketability of a TSE security, having the same price as a NYSE listed stock and experiencing a comparable level of trading activity, is inferior irrespective of its price volatility."[64]

The Toronto Stock Exchange has been caught between the inadequacy of a purely broker market to meet the liquidity needs of institutions and the fear of domination of the market by dealers or members who function as both brokers and dealers. But something might be *gained* by exploiting the role of members who act *solely* as dealers. If it is true that the quality of the marketplace is improved by a substantial flow of moderate-sized buy and sell orders, then a major contributor to market quality might be the individual member of a stock exchange who simply trades for his own account. At one time there were many such members of the New York Stock Exchange. But over the years the exchange discouraged this kind of membership. In late 1976, however, the Montreal Stock Exchange proposed to the Quebec Securities Commission a policy modification that would encourage individual members to trade for their own accounts.

One would expect the individual member trading for his own account to provide competition for official market-makers like the specialists on the New York Stock Exchange, and therefore to bring about an improvement in the specialists' performance. If the specialist undertakes to maintain a quarter point spread on a stock, then a member trading for himself may be able to exploit that spread to his own profit, thereby reducing the spread faced by the public customer, and perhaps forcing the specialist to narrow his spread. The member trading for himself is able to do what the public customer cannot effectively do because his commission charges are lower than the charges to the public customer. In a market where there are no specialists charged with a responsibility for maintaining bid and ask quotes, the individual member trading for his own account serves as a sort of unofficial specialist,

64 Tinic & West, *supra* note 49, at 742-43.

taking the "other side" of transactions with public customers. The Toronto Stock Exchange, however, would probably argue that this unofficial specialist is too likely to take advantage of the public.

The MSE proposed a reduction in the capital requirements for individual members trading only for their own accounts. Quebec Securities Commission Policy No. 21 requires $150,000 of capital for a registered broker and his net free capital must be at least $75,000. The commission raised some questions about the objectives of the exchange and the details of the activities of members trading for their own accounts. In early 1977 the exchange modified its proposal somewhat and in June 1977 the commission approved a system of individual market makers.[65]

The commission insisted that the exchange spell out the market-making obligation of these members. It also insisted that should the member have a non-member partner, the partner should be required to disclose the existence of all other accounts in which he directly or indirectly participates. The commission agreed that orders of market-makers would rank equally with orders originating from the public at the same price but would not consent to the market-maker member also acting as a trading representative on behalf of a broker.

9. *Studies of Market Fragmentation*

The issue of market fragmentation has been critical in the debate over commission structure and principal trading in Canada as well as in the proposals for a National Market System and in the arguments over off-board trading in the United States. The exchanges have argued strenuously that the quality of the market in listed stocks depends heavily on concentration of trading in that market.

The issue is an important one and both the SEC and the Ontario Securities Commission have expressed general approval of the idea of centralized markets and some fear of the effects of fragmentation, with trading in a stock taking place in several market centres. We have already seen that Demsetz found that the quality of trading (the spread, as he measured it) did not seem to be affected by fragmentation.[66]

In the spring of 1977 the SEC Directorate of Economic and Policy Research began some research on the extent of fragmentation in trading of NYSE listed stocks. A memorandum dated May 10, 1977, described statistical tests based on trading for the week

65 8 QSC Bull. No. 26 (Decision No. 5257, July 5, 1977).
66 *See* materials in note 61 *supra*.

March 21-25, 1977, in 854 stocks that were traded both on and off the floor of the New York Stock Exchange during the week.[67] The study was mainly concerned with the proportion of order flow directed to the New York Stock Exchange, that is, the extent to which the New York exchange was the central market for these stocks.

For all of the stocks the exchange accounted for 85% of dollar volume, share volume, and number of trades. But while the New York Stock Exchange accounted for at least 50% of the number of trades in every stock, it accounted for as little as 10% of dollar volume and share volume in at least one of the stocks. It appeared that large block transactions were a little more likely to occur on the regional exchanges, on NASDAQ, or on Instinet. The proportion of dollar volume and share volume occurring on the New York exchange was found to vary inversely with total dollar and share volume on all exchanges. In other words, the more heavily a stock is traded, the smaller the proportion of the trading that takes place on the New York exchange. But the effect was rather small. The proportion of the number of trades occurring on the New York exchange was inversely related to the total number of trades in all markets, but here the effect was much stronger. All of this seems to confirm that the principal marketplace attracts business, because it is the "best" market, until total volume reaches a level such that even the satellite markets are "good enough", and as volume continues to increase a smaller share goes to the central market.

A continuation of the study was reported in a memorandum dated June 17, 1977.[68] For this work the list of stocks studied was narrowed to sixty-five very active stocks. In this case trading on the New York exchange accounted for 78% of total dollar volume and share volume and 75% of the number of trades. The lower percentages of New York participation are consistent with the earlier finding that the more active a stock is, the smaller the proportion of trading on the New York exchange. It also appeared that for these actively traded stocks, there was no evidence that blocks were being traded away from New York.

E. EFFICIENCY IN PRIMARY MARKETS

Reference has already been made to the linkage between primary and secondary securities markets and to the theory that predicts efficient allocation of real investment as a consequence of

67 S. Phillips & P. Martin, Off-Board Trading Restrictions: app. A, memo to the [Securities and Exchange] Commission (May 10, 1977).

68 S. Phillips, Off-Board Trading Restrictions: Continuation of app. A, Memo to the Securities and Exchange Commission (June 17, 1977).

efficient securities markets. The theory, and some conclusions as to its validity, were described in 1965 in a classic study by William J. Baumol.[69] Baumol pointed out that the level of stock prices is an indicator of the cost of equity capital which is in turn an indicator of the rate of return a business should achieve on new investments. With respect to efficiency, he said:

> "The role of guardian of efficiency is one which it is natural to expect to be assigned to the stock markets. One would think that the firm which employs funds ineffectively would find itself denied easy access to them by an alert capital market, whereas the efficient user of resources should be able to obtain them cheaply and easily. Thus rewards and punishments would be meted out by the market and management's collective nose kept to the grindstone by anticipated future capital needs."[70]

As a practical matter, however, Baumol reached a discouraging conclusion. He observed that corporations in the United States simply avoided the equity market and many of them went for decades without a single issue of common stock.[71] While it was still possible that the stock market was exercising an indirect discipline on the use of capital by corporations, because managements are still concerned about the price of their corporation's common stock even if they are not issuing new stock, Baumol was sceptical even about this indirect influence. He quoted a British study that found no correlation between corporate growth in earnings and the rate of reinvestment by those corporations,[72] suggesting that there had not been efficient allocation of real investment in Britain, and he remarked that empirical analysis of the United States market was in process.

That analysis was reported in 1970 in the form of regression equations relating rate of return on new investment by U.S. corporations to the source of capital: debt, newly issued equity and reinvested earnings. For the period 1949–63 the rates of return were 4% to 14% on debt, 14% to 21% on new equity, and only 3% to 5% on retained earnings.[73] To the extent that corporations actually raised new equity capital in the market, the discipline of the marketplace appeared to be effective. But the indirect discipline seemed not to work. It may have made its contribution, but if so

69 W. Baumol, The Stock Market and Economic Efficiency (1965).

70 *Id.* at 66-67.

71 *Id.* at 67-69.

72 *Id.* at 76-77. The British study was the celebrated one by Little, *Higgledy Piggledy Growth*, 24 Bull. Oxford Inst. Statistics 24 (November 1962).

73 Baumol, Heim, Malkiel & Quandt, *Earnings Retention, New Capital and the Growth of the Firm*, 52 Rev. Econ. & Statistics 345 (November 1970).

that contribution was swamped by other factors such as tax rules and government regulation.

We are left, then, with reason to believe that corporations do allocate real investment so as to earn on investments financed by new equity a rate of return reasonably consistent with the probable cost of that equity in the marketplace.

1. *The Primary Market for Equity Securities*

With respect to unseasoned equity offerings, the kind that are of chief interest, at least three questions may be distinguished. First, do new firms have adequate access to equity markets and if so, at what cost? Second, do those who invest in unseasoned equities receive fair returns and do they generally have adequate information on which to base their decisions? Third, are there structural features of the investment industry that are undesirable (anticompetitive features, for example) and what would be the effects on that structure of any policy actions directed toward the first two questions?

a. *Issuer Costs*

The cost of raising equity capital has two components. The first is a new issue premium and the second is the direct cost of underwriting or the investment dealer's spread, the difference between the price at which the security is sold to the public and the amount received by the issuer.

Concerning the new issue premium, if an issuer offers stock to the public and its price rises immediately after the offering, the net receipts of the issuer are presumably lower than they would have been if the securities had been priced just right. The difference between the offering price and the immediate after-market price reflects the new issue premium or the amount of underpricing that was thought necessary to sell an unseasoned stock in a short time.

If, other things being equal, the prevailing degree of underpricing appears excessive, the equity-seeking firm may simply believe it has been priced out of the market. It may postpone or completely forego the new issue and as a result it may grow more slowly. One way of testing for this phenomenon is by examining the rate of return performance of new issues. If the primary securities market is efficient so that new issue premiums are not excessive, the returns to investors for a large sample of new issues bought on the day of the offering and held for some short or intermediate holding period should be comparable to the returns on previously outstanding securities of similar risk.

Within the last several years at least three analysts have studied the question of price performance of new issues in the United States during the 1960s and 1970s.[74] Each made great efforts to adjust for volatility and to assure that errors in measurement would not bias the results. Despite each researcher's choice of a distinctive methodology, the results were all very similar: after adjusting for market-wide movements in stock prices and the risk of the securities, *new issues were found to appreciate in price by about 20% between the time they were offered and the end of the month during which they were offered.* In addition, each researcher examined the price performance of new equity issues between the end of the month during which they were offered and some later date, generally seven months to one year. Again, each reached a similar conclusion: after the initial price surge, these securities integrated with the general market and investors were not able to achieve extraordinary returns by buying a few weeks after the offering. The general conclusion from these analyses is that if there is any inefficiency in the market for new equity issues it has to do with the initial price set by the investment banker in consultation with the issuer and not with the market mechanism itself.

A similar study was conducted for Canadian new offerings during the period 1956–63.[75] For seasoned issues (stock of the issuer was already outstanding in the hands of the public) the conclusions tended to contradict those described above for the United States. Underpricing did not occur. These conclusions could reflect differences in the time periods for the issues or (and this is discussed later) they may reflect differences in institutional arrangements between Canada and the United States, particularly those pertaining to underwriter compensation.

For unseasoned, relatively high-risk new issues, the Canadian study suggested overpricing: the new issues underperformed outstanding issues. But as the study points out, this apparent overpricing may simply reflect an investor attitude toward risk that differs as between high-risk, unseasoned issues and other issues. The possibility of a high-return "long shot" may attract investors to the unseasoned stocks.

74 *See* Logue, *Risk-Adjusted Performance of Unseasoned Common Stock Offerings*, 12 Q. Rev. Econ. & Bus. 67 (winter, 1972); R. Ibbotson, Price Performance of Common Stock New Issues (1974) (Ph.D. dissertation, University of Chicago); D. Downes, The Investment Performance of Unseasoned New Issues (1975) (Ph.D. dissertation, Cornell University).

75 Shaw, *Hot New Issues: How Do They Perform?*, 34 Bus. Q. 42 (Summer 1969); Shaw, *The Performance of Primary Common Stock Offerings: A Canadian Comparison*, 26 J. Fin. 1101 (December 1971); D. Shaw, The Market for New Equity Issues in Canada (1968) (Ph.D. dissertation, University of Pennsylvania).

The second component of the cost of new equity offerings is the underwriter spread. While little work has been done on this issue, there are some insights in the literature. Several studies have shown that the magnitude of the spread is inversely related to the degree of underpricing.[76] Moreover, an important but only partially substantiated conjecture suggests that initial underpricing exists largely because there are institutional limitations on the size of the underwriter's spread in the United States.[77]

Selling new equity issues is difficult and expensive. The underwriter can make its job easier by underpricing the issue, so as to attract investors, and charge a low spread. Alternatively the underwriter can try to sell the issue at a price close to the market and charge a high spread for the extra effort involved. Institutional limitations on the size of the underwriting spread may preclude the use of the second strategy, for the costs of the extra effort may exceed the limits set by a regulatory authority. From the point of view of the issuer, any limitations on the spread may simply switch his costs of raising equity from one form, direct underwriter compensation, to another, underpricing.

If the foregoing is correct, then one reason why underpricing of new equities may not be as common in Canada as in the United States is that there are fewer institutional limits on the magnitude of underwriter spreads. And, by induction, this contrast suggests that the preferred form of the capital-raising cost to the issuer may be through direct payment to underwriters rather than indirect payment to investors.[78]

One public policy conclusion that may be derived from this discussion is that no regulatory or statutory limitations should be placed on the magnitude of underwriters' spreads. So long as the market for underwriting services is competitive, the total cost of raising new equity capital will tend to be kept at a minimum by the private decisions of issuers and investors.

There is not much evidence available on underwriting spreads and commissions in Canada. In 1961, I concluded that the underwriting spread itself was lower in the United States but that the

76 Logue, *On the Pricing of Unseasoned Equity Issues: 1965–1969*, 8 J. Fin. & Quantitative Analysis 91 (January 1973); and Logue & Lindvall, *The Behaviour of Investment Bankers: An Econometric Investigation*, 29 J. Fin. 203 (March 1974).

77 Logue, *Premia on Unseasoned Equity Issues*, 25 J. Econ. & Bus. 133 (spring-summer 1973).

78 A similar conclusion emerges from D. Logue & R. Jarrow, Rule 50 of the Public Utility Holding Company Act of 1935 (unpublished 1976), dealing with the question of whether the rule requiring competitive bidding for security issues of regulated utility holding companies was effective in reducing the cost of raising capital. It was shown not to be.

other expenses of an underwriting of debt were lower in Canada.[79]

A much more recent study by J. Peters concluded that for public debt offerings of $5 million and over, underwriting spreads were lower in the United States but other expenses were higher. For offerings between $1 million and $5 million, underwriting spreads and other expenses were lower in Canada, while for offerings under $1 million, underwriting spreads were lower in the United States but expenses were higher. Total costs of underwriting were lower in the United States for offerings of $5 million and over and higher for smaller offerings. For private placements the Canadian agent's fee was larger than the American fee for all sizes of placement.[80]

Peters drew the conclusion that private placement agency fees in Canada were higher than necessary, presumably because of lack of competition. And he suggested that Canadian spreads on public offerings were too high relative to U.S. spreads.[81] He described the Canadian underwriting business as not very competitive and he referred specifically to the high degree of concentration reported by the Royal Commission on Banking and Finance (the Porter Commission) in 1964. Bond underwriting in Canada is directed much more to individual (as opposed to institutional) investors than is underwriting in the United States, and this may help to account for higher spreads in Canada.

All of these comparisons relate to debt rather than equity offerings, of course, but they suggest a greater reliance on spreads and lesser reliance on underpricing in Canada.

b. *Adequacy of Information*

An interesting question is whether disclosure aspects of the regulation of securities markets and new offerings has had any effect on efficiency. We shall look at other aspects of regulation later in this chapter.[82]

Irwin Friend has been the principal spokesman for the contribution of disclosure regulation to efficiency and in 1976 he published a review of his own findings, as well as a review of the findings of George Stigler, who has consistently argued that the regulation has *not* improved efficiency.[83] Research has been aimed

79 J. Williamson, Effects of Securities Regulation on Canadian Corporate Financing 22-23 (1961) (unpublished D.B.A. dissertation, Harvard Business School).

80 J. Peters, Economics of the Canadian Corporate Bond Market 53-55 (1971).

81 *Id.* at 69.

82 *See* text accompanying note 108 *infra.*

83 Friend, *Economic Foundations of Stock Market Regulation*, 5 J. Contemp. Bus. 1 (summer 1976).

at identifying differences in the behaviour of (1) new issues subject to full disclosure and those exempt from full disclosure (small, regulation A issues), (2) new issues before the coming of the SEC and new issues since, and (3) new issues subject to full disclosure and outstanding issues not so subject. Friend concluded that on the whole the research indicates that regulation has increased efficiency and that the benefits have exceeded the costs of the regulation.

In a study in the mid-1960s, George Stigler[84] found that the average performance of new issues before establishment of the Securities and Exchange Commission and its financial disclosure requirements was about the same as after. The rules on the amount and quality of information that new equity issuers had to divulge had no effect on average performance. However, the *range* of performance of new equities was considerably greater (generally more than double) in the pre-SEC than in the post-SEC period. There were more big winners and big losers before the SEC than after.

One generalization that may be drawn from the Stigler result is that the enforcement of a set of accounting and reporting standards and required dissemination of this information through prospectuses led to better pricing of securities, or at least fewer extreme cases of malpricing. In the absence of required information, investors' decisions to purchase or not purchase new equities depend heavily on the information provided by the underwriter. Similarly, the issuer, having little specific financial knowledge on comparable firms, is largely dependent on the underwriter for guidance. The net result may be that the dispersion of return or price performance is greater than it would be if audited information on issuers and comparable firms were routinely available. With such information both issuer and investor decisions could be made on sounder bases than otherwise.

The thrust of this argument is that there may be considerable benefit to uniform disclosure and registration statement policies for firms offering new equity. Since information is costly and there are probably economies of scale in generating information, to require the production and dissemination of some minimally useful financial reports (prospectuses) will tend to economize on investors' information gathering costs and reduce risks to both investors in and issuers of new equities.

The requirement that a prospectus be accepted for filing before a new issue of securities is offered to the public is an obvious

84 Stigler, *Public Regulation of the Securities Markets*, 37 J. Bus. 117 (April 1964); comment, 37 J. Bus. 414 (October 1964). Friend, *supra* note 83, comments on Stigler's work

hurdle for new financing. The disclosure required may be difficult, or simply unwelcome to the issuer. Preparation of the filing may be expensive. And the whole process may be time-consuming. Figures 2, 3 and 4 are based on an analysis of all prospectuses accepted for filing in Ontario, Québec and British Columbia for the years 1969–74. For industrial and mining company issues, clearance generally seems to require thirty to sixty days. There is no indication that the clearance process slowed over these years. For mutual funds, although sixty days is the most common time for clearance, a significant number were cleared in only fourteen days. There is some evidence of a lengthening of the average clearance time over the years.

Small businesses may be heavily burdened by modern disclosure requirements, and in the United States the SEC has tried to reach a compromise between a level of disclosure adequate to inform investors and one that does not stifle a small enterprise. In March 1978 the SEC announced that it would hold hearings on the effects of disclosure requirements on small businesses, and reviewed evidence that the current requirements went too far in favour of investor protection and were excessively burdensome on the businesses.[85] At the same time the commission proposed a simplified registration statement for offerings of securities not exceeding $3 million.[86]

c. *Structure of the Investment Dealer Industry*

For a long time there has been widespread suspicion that the investment banking industry in the United States has been a closely-knit club whose established members effectively exclude competitors.[87] In fact, there has been at least one major legal suit brought against investment banking firms by the U.S. Department of Justice.[88] Although the suit was dismissed, opinion persists that investment banking firms are collusive.

If the investment banking industry is cartelized or is characterized by imperfect competition, then appropriate antitrust remedies are available. However, there may be very good economic reasons why a small group of firms has gotten most of the investment banking business, particularly prior to the formation of the SEC, and these reasons give further support to the notion that

85 SEC, Securities Act of 1933 Release No. 5914, March 6, 1978, [1978-1979 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 81,530.

86 SEC, Securities Act of 1933 Release No. 5913, March 6, 1978, [1978-1979 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 81,532.

87 *See e.g.* West, *Bidding Competition for Municipal Bonds: The William Morris Episode*, 21 Fin. Analysts J. 119 (July-August 1965).

88 United States v. Morgan Stanley & Co., 118 F. Supp. 621 (S.D.N.Y. 1953).

Figure 2
Prospectus Clearance Times: Industrial Issues
Ontario, Québec and British Columbia



Figure 3
Prospectus Clearance Times: Mining Company Issues
Ontario, Québec and British Columbia

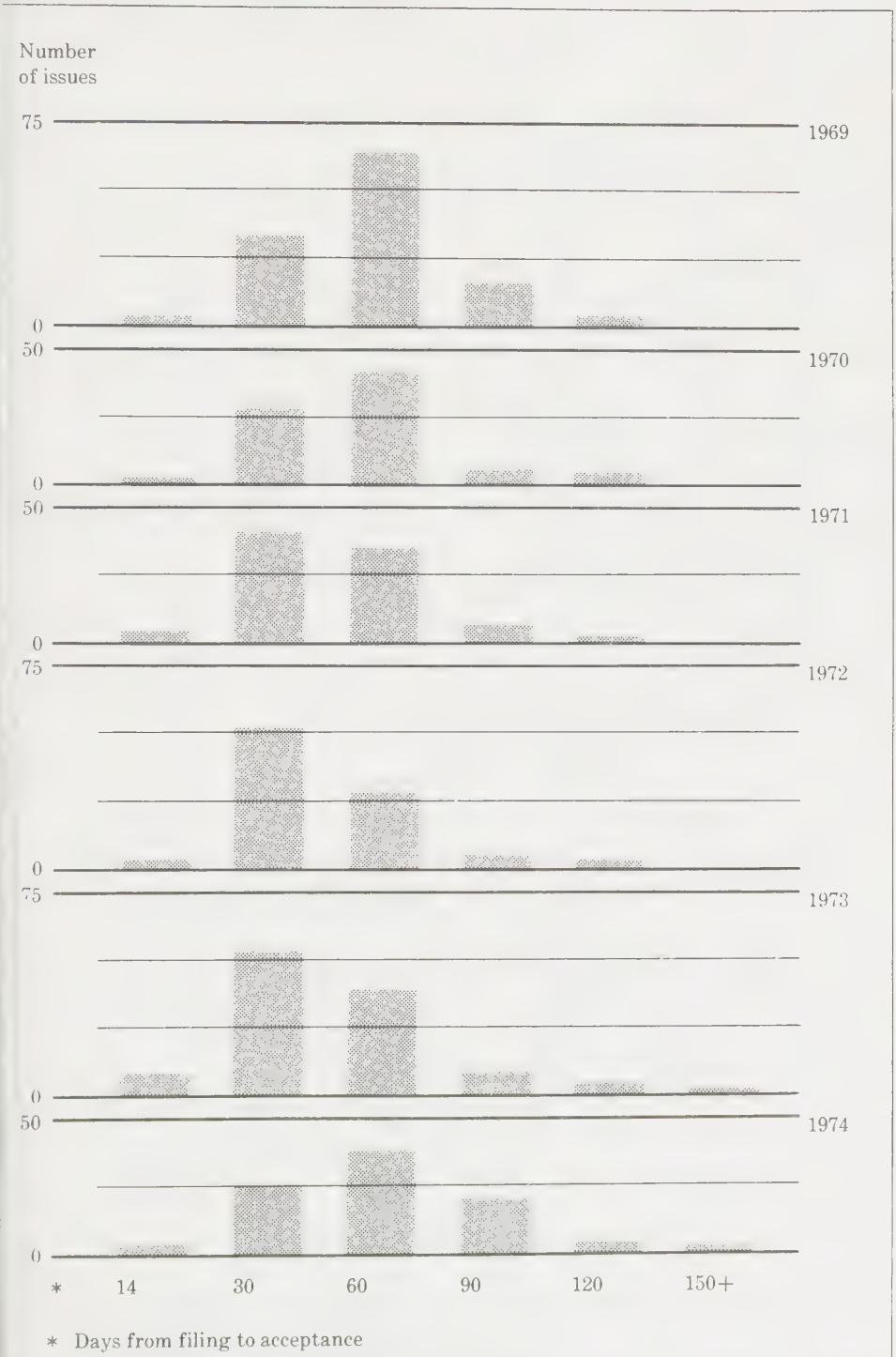


Figure 4
Prospectus Clearance Times: Mutual Funds
Ontario, Québec and British Columbia



enforced disclosure of financial information by equity issuers may be generally beneficial.

When information is costly to obtain, potential users of that information will seek ways to economize. One such way entails enlisting the service of an agent who can, because of a large number of customers, provide information to individual customers at lower charges than each customer would incur if he sought to gather that information on his own. However, the perceived quality of the information gathered by the intermediary depends on the reputation of the information gatherer. This logic may be extended to the investment banking or investment dealer industry.

Investors depend on investment dealers to provide and verify information on new issues. To the extent that large, old, well-established investment dealers enjoy good reputations, investors will tend to prefer to do business with them, for the perceived quality of the information is high. In turn, issuers will tend to seek the services of these firms for they will have better access to investors. Firms issuing unseasoned equities generally have no visibility among investors prior to the issue; they have no reputation for providing useful information. But since investors know investment dealers' reputations, the investment dealers can substitute their reputations for those of the firms they underwrite. One national consequence of such an informal "reputation-transfer" process is the creation of a barrier to entry to new competition. New investment dealers are at a distinct disadvantage because they lack the reputations of the old. As a result, the business of new firms will tend to be limited to underwriting equity issues by new issuers who are too small to pay the fees for using a large firm and to assisting large investment dealers in the distribution of the securities they underwrite.

One way of encouraging new competition is to remove the barriers to entry, in particular, reputation-transfer. This transfer may be accomplished by assuring that all new equity issuers provide uniform information to potential investors and that the information be reviewed by some entity with a reputation.

The requirement for firms to file audited prospectuses will not only tend to reduce the risks of issuers and investors alike but will also tend to enhance competition among investment dealers. The enhanced competition should serve to reduce total new issue costs.

F. BROKER RESEARCH AS A CONTRIBUTOR TO MARKET EFFICIENCY

Almost all of the submissions on fixed commission rates made to the Ontario Securities Commission in 1976 stressed the impor-

tance of an efficient securities market. And most of them expressed the belief that broker research is an important element in producing this efficiency. More specifically, some submissions stressed the need for research from many independent sources (especially firms not engaged in underwriting) to produce a variety of investment evaluations and therefore presumably a wide variety of purchase and sale decisions.[89] Other submissions stressed a particular need for research directed toward retail customers which is generally a byproduct of institutional research.[90] This direction was seen as necessary to maintain the trading of independent investors, said by many of the submissions to be critical to an efficient marketplace. Still other submissions stressed the need for research on small and medium-sized companies on the grounds that these are the companies that have the greatest difficulty undertaking primary financing and therefore the ones for which it is most important to develop a satisfactory secondary market.[91]

On the other hand, a number of institutions (chiefly trust companies and life insurance companies) expressed some reservations about the present flow of broker research. These institutions generally described the research they were getting as useful and of high quality but said there was too much of it.[92] Some said they could do with less repetition and some expressed the hope that quality would replace quantity. Others said that too much research is directed to institutions and retail customers are neglected.[93]

It is interesting that while many of the submissions supporting continued fixed commission rates expressed fear that institutions would drive unfixed commission rates down to the point where research would disappear, not a single institution in its submission gave any indication that *it* might do this. A number of institutions (again, chiefly trust companies and life insurance companies, which are the dominant trading institutions) were quite specific in stating that they were willing to pay for research through commissions.[94] It is true that some submissions raised a

89 *See e.g.* Sun Life Assurance, submission to OSC (June 1976); Great-West Life Assurance, submission to OSC (June 1976); Manufacturers Life Insurance, submission to OSC (June 1976); North American Life Assurance, submission to OSC (May 1976); Loewen Ondaatje McCutcheon, submission to OSC (July 1976).

90 *See* Montreal Stock Exchange, submission to OSC (June 1976); Toronto Stock Exchange, submission to OSC (June 1976).

91 *See* Moss Lawson, submission to OSC (April 1976); Bongard Leslie, submission to OSC (May 1976).

92 *See e.g.* Montreal Trust, submission to OSC (April 1976); Canada Permanent Trust, submission to OSC (June 1976); Great-West Life Assurance, submission to OSC (June 1976).

93 *See* International Trust, submission to OSC (April 1976).

94 *See e.g.* Montreal Trust, submission to OSC (April 1976); Confederation Life Insurance, submission to OSC (June 1976).

question whether the services, including research services, obtained by institutions from brokers benefitted the clients of the institutions or the institutions themselves.

A number of institutions expressed the opinion that there was simply no incentive to destroy sources of research.[95] The mutual funds took an especially strong position in favour of supporting research through commissions, admitting quite candidly that so long as the fees for managing a mutual fund are limited by the provincial securities regulators, it would be painful for the management companies to use their own money rather than fund commissions to pay for research.[96]

The submissions of a few trust and life insurance companies went into some detail on the importance of research in allocating brokerage commissions. Table 14 summarizes some of the statistics.

The trust companies and life insurance companies are in somewhat different positions, of course, on the value of broker research. The trust companies in their stock transactions are acting on behalf of clients and using client money to pay commissions which may in turn purchase research services. The life companies are working to a substantial extent with their own money when they pay commissions. Many, however, manage substantial amounts of client funds and there is therefore some opportunity to purchase research with client money. On balance, one might expect trust companies to be more cautious about reducing commission rates if this might mean a reduction in broker research.

Of twelve life insurance companies making submissions to the OSC, only three supported an immediate unfixing of commission rates, while two others advocated a gradual move to negotiated rates. Of seven trust companies making submissions, two advocated unfixing commission rates immediately, and two recommended gradual unfixing. It is interesting that the largest trust company, Royal Trust, recommended a gradual move to negotiated commissions, while the second largest, Montreal Trust, recommended maintainance of fixed commissions.

Competitive commission rates in the United States do not seem to have brought about a significant decline in broker research, although some duplication is gone. But there has been some change in sources of research. Greenwich Research Associates reported in 1977:

> "Every one of the brokers who gained market share in research in our study this year was an investment bank-

95 *See e.g.* Royal Trust, submission to OSC (March 1976).
96 *See* The Investment Funds Institute of Canada, submission to OSC (1976).

Table 14
Factors in Allocating Brokerage Commissions for Trust and Life Companies

1976

	Royal Trust[a]		Mutual Life	Confederation Life
Research	45%	54%	65%	60%
Economic research	10	13	10	
Coverage (salesman)	36		15	32
Execution	9	33	10	8

a. The first column excludes broker-originated trades, and the second column includes them.
Source: Submissions to the Ontario Securities Commission, 1976.

> er. All of the brokers who lost market position in research were 'institutional' firms.
>
> "For the investment banking firms, the institutional-research-agency business is not so much an end in itself as it is a means of achieving another purpose: distribution. Just as the production companies in the oil industry sought downstream distribution outlets, the major investment banking firms need access in size to the institutional market to protect and strengthen their major bracket status in corporate underwritings."[97]

A number of studies have been undertaken in the United States on the value of broker research. One of the most thorough was that of Logue and Tuttle,[98] which examined recommendations to retail clients of six major United States brokerages from July 1970 through June 1971 and compared the results of following these recommendations to the results of choosing stocks at random. The recommendations consisted of 277 buys, 27 qualified buys, 40 holds, 2 qualified sells and 18 sells. The authors concluded:

> "This paper examined the investment performance of brokerage house investment recommendations and compared it with the performance of randomly selected securities. After analyzing the recommendations of a small group of brokerage firms, it concluded that an investor who routinely follows the advice of his brokerage firm would do, on balance, as well by randomly selecting securities.... There are many investors who would have absolutely no idea as to what to buy or sell without advice of some sort or another. To the extent that they would otherwise not invest, except for brokerage firm investment advice, and since it appears that such advice is not generally harmful, brokerage firm investment advice serves a valuable purpose. What is objectionable, however, is that the cost of these services is included in the fixed minimum commission schedule and that investors therefore pay for investment advice, whether they desire it or not."[99]

Some interesting views of retail customers themselves on the value of broker advice in the United States were reported by the New York Stock Exchange in 1974.[100] Interviews were conducted

97 Greenwich Research Associates, Fourth Annual Report on Institutional Brokerage Services at i (1977).

98 Logue & Tuttle, *Brokerage House Investment Advice*, [1973] Fin. Rev. 38.

99 *Id.* at 54.

100 New York Stock Exchange Research Department, Planning for Competitive

with individual investors to explore investor needs and attitudes. The summary of the report said:

> "Individual investors tend to psychologically cluster brokerage services into two types. Investors place primary importance on those services representing direct profit-making tools, such as research and timely investment advice....
>
> "Many investors feel that quality investment advice is available but difficult to obtain since registered representatives currently function as both investment counselors and salesmen. Investors view this dual role as incompatible with their best interests and would prefer a more equitable compensation system. They also complain that there is too much pressure on registered representatives to produce, too little advice when to sell or move to a cash position, outdated and poor quality research, and pretended competence by registered representatives in many areas in which they are actually naive or unknowledgeable.
>
> "Because of widespread disenchantment with investment advice received from brokerage firms in recent years, many investors have downgraded their expectations of the registered representative and try to rely on their own judgment and independent research....
>
> "[T]he view of the representative as a valued partner is far less common than the attitude that he is a force to be resisted rather than embraced in the investment-making process."[101]

On the specific issue of competitive commission rates, the report said:

> "Competitive commission rates are welcomed by most individual investors as a sign of industry recognition of the importance of the individual investor. Additional competition is viewed as an impetus for member firms to develop greater efficiencies which will result in improved services for the individual investor. The key appeal of competitive rates to the investor is the belief that he will be able to select and pay for only those services he really wants....
>
> "The idea of an execution-only concept is viewed favourably by investors. A definite demand for this service

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Commission Rates: Investor Attitudes Towards Brokerage Services (August 1974).

101 *Id.* at 2, 3.

> exists, particularly if a New York Stock Exchange member firm offers it."[102]

Even before commission rates in the United States became competitive in 1975, the use of commissions to buy research for managers of "other people's money" was suspect as a possible breach of fiduciary duty.[103] But at least the manager could argue that there was no way to reduce commissions paid through reduction or elimination of research received. Since commission rates have become competitive, however, a manager may be able to minimize the commission cost to customer accounts by purchasing only the necessary execution services. Mindful of what this might do to providers of research, Congress added section 28(e) to the Securities Exchange Act of 1934 in the course of the 1975 amendments. Section 28(e) provides explicitly that:

> "no person...in the exercise of investment discretion with respect to an account shall be deemed to have...breached a fiduciary duty under State or Federal law...solely by reason of his having caused the account to pay a member of an exchange, broker, or dealer, an amount of commission for effecting a securities transaction in excess of the amount of commission another member...would have charged for effecting that transaction, if such person determined in good faith that such amount of commission was reasonable in relation to the value of the brokerage and research services provided by such member...."

This subsection authorized what is known as "paying up" for research. There have been a good many denunciations of section 28(e)[104] and the SEC has proposed a set of disclosure requirements that would seriously restrict its usefulness to managers. Managers would have to disclose how they select brokers, what research and other services were purchased with commissions, and the commission paid.[105] The consequences of section 28(e) may be a "regulatory nightmare"[106] and the practical difficulties in using the section are horrendous.[107] But without it the use of commissions to

102 *Id.* at 5.

103 *See* Pozen, *Money Managers and Securities Research*, 51 N.Y.U.L. Rev. 923, 955-58 (1976).

104 *See id.* "Paying up" is further discussed in ch. V of *Williamson, Financial Institutions.*

105 SEC, Securities Act of 1933 Release No. 5772, Nov. 30, 1976, [1976-1977 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 80,815. The SEC has also had to issue a number of rulings on what services fall within the protection of s. 28(e) and from whom they may be purchased; *see* Pozen, *supra* note 103, at 959-64.

106 Pozen, *supra* note 103, at 964.

107 Stark, *Problems of Institutions under Competitive Rates: "Paying Up" for Research,*

purchase research would raise serious fiduciary problems for many managers. And some of these managers are simply unable to pay cash for research and charge the cash expenditures back to customers, or to raise the fees charged to customers.[108]

G. EFFECTS OF REGULATION ON EFFICIENCY

There has been substantial argument, and not much agreement in the United States in recent years, over the effects of federal regulation of securities markets. Has the coming of the SEC made these markets more efficient or at least more efficient than they would have been without an SEC? We have already considered the effects of disclosure requirements.[109] Here we are concerned with something different.

SEC regulation, at least of new offerings of securities, is essentially aimed at full disclosure. State "merit regulation" is aimed at screening out unsuitable securities and simply preventing their sale or setting conditions having to do with the method of underwriting and sometimes with the issuer's internal financial arrangements which must be met before an offering is allowed.

A book published in 1971[110] was critical of merit regulation, claiming its disadvantages outweighed its benefits. A 1976 article, on the other hand, compared the performance of securities registered in Wisconsin with that of securities denied registration there and concluded that the screening had been beneficial.[111] This article, however, has been criticized as being so badly done as to be useless in another article referring to a study that showed no significant difference between securities registered in North and South Carolina and those denied registration there.[112]

Two studies have examined the narrow issue of trading suspensions – a regulatory device used by both stock exchanges and securities commissions to halt trading in an issue. The New York Stock Exchange frequently (perhaps three times a day) orders temporary suspensions of trading, either because a specialist reports a serious imbalance of buy and sell orders, or because of the disclosure or pending disclosure of news likely to have a significant impact on a stock price.

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in PRACTISING LAW INSTITUTE, SEVENTH ANNUAL INSTITUTE ON SECURITIES REGULATION 355 (R. Mundheim, A. Fleisher, B. Vandegrift eds. 1976).

108 Pozen, *supra* note 103, at 973-77.

109 *See* text accompanying note 82 *supra*.

110 J. MOFSKY, BLUE SKY RESTRICTIONS ON NEW BUSINESS PROMOTIONS (1971).

111 Goodkind, *Blue Sky Law: Is There Merit in the Merit Requirements?* [1976] WIS. L. REV. 79.

112 Mofsky & Tollison, *Demerit in Merit Regulation*, 60 MARQUETTE L. REV. 367 (1977).

An analysis of over 900 temporary trading suspensions on the New York exchange during the bear market from late February to December 1974 and the bull market from December 1974 to June 1975 was reported in 1976.[113] There were generally large price adjustments between the last trade before suspension and the first after trading was restored and little or no adjustment after the restoration of trading. This suggests that the suspensions improved efficiency – that the prices when suspension took place did not adequately reflect information but that when trading was restored they did.

A study of 134 stock suspensions on four stock exchanges in Canada from 1967 through 1973 drew the same conclusions for cases when favourable information was disseminated during the suspension period. But where the news was unfavourable, there was still significant price adjustment after trading was restored.[114] Once again, regulatory interference appeared either to increase efficiency or to protect investors by delaying trading until new information had been absorbed and reflected in prices.

Neither study indicated what suspensions may cost investors in lost marketability, an element that detracts from the benefits.

H. SPECIALIZED SECURITIES MARKETS

The discussion so far in this chapter has concerned conventional markets in stocks and bonds. These are the markets that are best understood and that have been most analyzed. But new markets, sometimes for new instruments, are constantly emerging. The money market has become significant in both the United States and Canada just within the past twenty years. Provincial and municipal securities markets have been with us for many years but recent events in the United States suggest that some changes may be coming. Mortgage loans are a familiar investment vehicle but no one has yet succeeded in developing an entirely satisfactory secondary market for mortgages. (Some U.S. institutions, however, have made a good deal of progress.) Commodity futures are not new but the market in financial instrument futures is new and promising.[115]

These specialized markets are discussed here briefly. Listed

113 Hopewell & Schwartz, *Stock Price Movement Associated with Temporary Trading Suspensions: Bear Market Bull Market*, 11 J. FIN. & QUANTITATIVE ANALYSIS 577 (1976).

114 L. Kryzanowski, *Some Tests of the Efficacy of Security Regulation in Canadian Capital Markets* (1976) (Ph.D. dissertation, University of British Columbia).

115 In Ontario, Bill 8, 31st Leg., 2d Sess., 1978 (An Act to Regulate Trading in Commodi-

stock options are not yet five years old but they are a well established, if not perfectly understood, investment vehicle. They are a minor part of the Canadian securities market but they may also have much to offer. The market in American state and municipal bonds has undergone recent changes that may forecast some change in Canada. Finally, developments in the U.S. mortgage market may suggest opportunities for Canada.

1. *Listed Stock Options*

Put and call options on common stocks have been available as investment vehicles in the United States for many years. Until 1973, however, options were generally regarded as highly speculative and there was no well organized market for them. In that year, the Chicago Board Options Exchange was established, investors were presented with an auction market and visible prices, and dealings in options began to gain in respectability. In 1975 the American Stock Exchange and the Philadelphia Exchange initiated trading in call options. The Pacific Coast Exchange and the Midwest Exchange followed in 1976.

As of mid-1977 call options on about 209 stocks were being traded on the five exchanges. All of the stocks were listed, almost all of them on the New York Stock Exchange. The New York exchange itself was considering options trading but was held back because of questions about the propriety of trading both the stocks and the options on the same exchange.

Trading began in 1977 in put options on the five exchanges and puts were available for about sixteen issues in the fall of 1977.

When trading in listed options began in the United States, Canadian regulatory authorities had difficulty deciding whether to allow Canadian brokers to participate in this market. It was a new kind of market with unknown risks. At the same time, the Canadian securities industry would not benefit if Canadian participation in the United States market was all to be channeled through American brokers.

In late 1974 the Chicago Board Options Exchange (CBOE) applied to the Ontario Securities Commission for an order that would allow trading in Ontario of Chicago Board Options. The CBOE pointed out that technically an option is a security and the writing of an option is a trade in security that would appear to call for the issue of a prospectus. However, over-the-counter option writing had gone on in both the United States and Canada for

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(5 Futures Contracts) was introduced in February 1978, and received third reading in June 1978).

many years without any demand that prospectuses be issued. It would, of course, be impractical to issue a prospectus each time an option is written. But the formal exchange market in listed options called for some formal disclosure. The answer that had been developed in the United States was for the Options Clearing Corporation, the entity that technically issued all listed options, to file a prospectus disclosing in detail the operation of the options market but no specific information on the underlying stocks which were already listed stocks. The CBOE proposed the same procedure for Ontario.

The Ontario Securities Commission granted the request,[116] subject to a condition that trading in Chicago Board Options would be restricted in Ontario to members of the Toronto Stock Exchange, which had undertaken to amend its by-laws, regulations and policies to assure protection for the public as well as its own members. In May 1975 the TSE issued to its members a "guideline" for the conduct of a public business in options issued by the Options Clearing Corporation which by that time was handling options on both the CBOE and the American Stock Exchange.

Both the Toronto and Montreal stock exchanges then began to develop option trading programs of their own. The two exchanges discussed the feasibility of a single options clearing corporation following the U.S. pattern. But the negotiations broke down and in September 1975 the Montreal Stock Exchange, through its Montreal Options Clearing Corporation, began trading options. The Toronto Stock Exchange was somewhat slower in developing its own options market and its own clearing corporation – the Canadian Clearing Corporation for Options Limited. It applied to the Ontario Securities Commission in February 1976 for an order permitting trading. The Montreal Stock Exchange and its clearing corporation applied at the same time for an order permitting trading in Ontario. The commission expressed some unhappiness at the inability of the two exchanges to establish a single clearing corporation but given assurances that the exchanges would endeavour to do this in the future, it gave the requested permission to both exchanges.[117]

In May 1977 the Montreal and Toronto stock exchanges finally reached agreement and the Montreal Options Clearing Corporation and the Canadian Clearing Corporation for Options Limited were replaced by Trans-Canada Options, Inc. (TCO), which provides a single clearing facility for all options traded in the Montre-

116 *In re* Chicago Board Options Exchange Clearing Corporation and Section 20 of the Securities Act, [1975] OSC Bull. 22 (January).

117 *In re* Montreal Options Clearing Corporation and the Canadian Clearing Corporation for Options Limited, and s. 20 of the Securities Act, [1976] OSC Bull. 93 (March).

al and Toronto exchanges. TCO is jointly owned by the two exchanges.

In August 1977, the Ontario commission issued a ruling permitting trading in Ontario in put option contracts traded on United States exchanges.[118]

The trading of call options on registered stock exchanges in the United States had become well established by late 1977. Volume was substantial; trading on the Chicago Board alone might amount to 100,000 contracts on a day on which the New York Stock Exchange traded 20 million shares. Each contract represents an option on 100 shares, so the shares underlying the contracts traded might amount to about half the New York Stock Exchange volume. Brokers have found option trading very profitable and the value of a membership on the CBOE has risen rapidly, while memberships on the New York exchange have declined in value.

Trading of options on the Toronto and Montreal stock exchanges was through 1977 much less active, although it rose late in the year. A day's trading might amount to 2,000 contracts (in twenty-six stock issues) compared to a volume of 2 million to 2.5 million shares on the two exchanges.

It is hard to assess the potential for the future. Canadian exchanges offer more opportunities for speculation in listed stocks than do American exchanges, so the speculator demand for options is likely to be less. On the other hand, as Canadian institutions discover the value of options in reducing volatility of stock portfolios, there may be a growing volume. Institutional activity in late 1977 was almost nonexistent.

2. *Provincial and Municipal Securities*

In both Canada and the United States provincial (or state) and municipal securities have traditionally been excluded from the scope of securities regulation. No prospectus has been required for new issues and no registration has been required to act as a broker or dealer in those securities. The exemptions have been based in part on an apparent absence of risk in these securities and in part on an unwillingness for one government to attempt to regulate another.

Canada seems to have escaped the difficulties experienced in the U.S. market for state and municipal securities. Whatever the quality of the securities themselves, there are opportunities for fraud and unethical practices in dealing in this market. There were enough examples of undesirable conduct to persuade Con-

118 [1977] OSC Bull. 198 (August).

gress to provide in the Securities Reform Act of 1975 for the registration of municipal dealers.[119] In addition, the financial difficulties of New York City and potential difficulties of other cities led to the establishment of the Municipal Securities Rulemaking Board to develop rules for the municipal securities market.[120]

A certain amount of enthusiasm for subjecting all municipal offerings to a full prospectus requirement has been shown, but it is also becoming apparent that the market itself demands, without legislative sanction, substantial disclosure from municipalities and states that borrow substantial amounts.[121]

3. *Mortgages*

Mortgage loans constitute one of the most important financing vehicles in North America. The efficiency with which savings can be channeled into mortgage loans is critical to housing and the construction industry. For many years both the United States and Canada relied largely on life insurance companies and savings institutions to provide residential mortgage funds, but in recent years attempts have been made to broaden the pool of savings that might go into these loans. However, mortgage loans differ from other investment instruments in several important respects. First, mortgage lending is a specialized activity that requires considerable skill. Only institutions with a substantial commitment to mortgage lending can afford to set up the necessary machinery. Second, mortgage loans come in substantial denominations. A single loan will represent several thousand dollars. So it is not practical for most individual investors to hold diversified portfolios of mortgage loans. Third, to most investors, particularly institutional investors, a mortgage loan is an odd kind of financial instrument. Investors accustomed to stocks and bonds and the dividend, interest and principal payment schedules associated with stocks and bonds have difficulty coping with the monthly amortization of mortgages. And finally, no satisfactory secondary market has been developed in mortgages to provide the marketability that is critical to many investors and that can be found in stocks and bonds.

One possible answer to the need for an efficient mortgage market is a mutual fund investing in mortgages. This can permit individuals to participate in a diversified portfolio and the fund

119 Securities Exchange Act of 1934, s. 15B.

120 *Id.*

121 Despite this, Senator Harrison Williams announced his intention, in the fall of 1977, to introduce the Municipal Securities Full Disclosure Act of 1977.

may either originate its own loans or work with other originating institutions. The absence of a secondary market presents a mortgage mutual fund with serious problems in the event that large redemptions require substantial liquidation. The lack of a secondary market also makes difficult the valuation of a portfolio and the pricing of fund shares. In Canada a few mutual funds do invest largely in mortgages. The managements of these funds are generally financial institutions with their own mortgage operation and this immediately suggests a potential for serious conflicts of interest when the manager-institution sells mortgages to the fund. The provincial securities commissions had great difficulty with the liquidity and conflict issues for some years. But in June 1977 the commissions finally approved National Policy No. 29 which deals with both matters. Minimum liquid asset holdings are specified, some quality standards are imposed on the mortgages acquired by a fund, and procedures are set out to prevent or at least minimize overreaching on non-arms length acquisitions of mortgages.[122]

In the United States there do not appear to be any significant mortgage mutual funds. But some important innovations have succeeded in channeling large amounts of institutional investment funds into mortgages. The Federal Home Loan Mortgage Corporation (FHLMC), owned by the twelve Federal Home Loan Banks, and the Government National Mortgage Corporation (GNMA), a federal government agency, both issue mortgage participation instruments. FHLMC buys mortgages and finances the purchases through two types of instruments. Guaranteed mortgage certificates represent undivided interests in conventional residential mortgages and are designed to meet the needs of investors who are most comfortable with a bond-like instrument. These certificates return principal once a year in guaranteed minimum amounts regardless of the status of the underlying mortgages and interest is paid semi-annually. A second instrument, the mortgage participation certificate, represents an undivided interest in a pool of conventional mortgages and in this case the purchaser of the certificate receives each month a pro rata share of the principal payments collected on the mortgages in the underlying pool, including prepayments, and interest on the outstanding balance. FHLMC guarantees the timely payment of interest at the certificate rate and the full return of principal regardless of the status of the underlying loans. These certificates are, of course, designed for the investor who is comfortable with the payment terms of a conventional mortgage.

GNMA issues participations in pools of conventional mort-

122 [1977] OSC Bull. 145, 145-52 (July).

gages in the form of so-called "GNMA pass-through" certificates. As in the case of the FHLMC mortgage participation certificates, the pass-through certificate gives the holder a share of the monthly principal and interest payment from a pool of mortgages. The pass-through certificates have been enormously successful. In 1976, $13.8 billion of these participations were sold to the public. A substantial secondary market exists with trading of about $3 billion a month.

To a substantial extent, these three agencies reflect overall policy in the United States to force savers (and taxpayers) to subsidize home mortgages. Government guarantees, at taxpayer expense, hold down the cost of mortgages. And the Federal Reserve Board's Regulation Q, limiting interest rates that deposit-taking institutions may pay, does the same at the depositors' expense. The scheme breaks down when interest rates rise dramatically and depositors simply move their funds. Canada has fortunately followed a different course, benefitting from the efficiency of a relatively free market in interest rates for mortgages. But the unattractive features of the U.S. handling of mortgage financing should not obscure the advances that have been made. Canada still suffers from the traditional limitations in the form of the mortgage repayment and the lack of a secondary market.

I. CONCLUSIONS AND POLICY IMPLICATIONS

What is of concern to the national well-being is allocational efficiency in capital markets, for this efficiency will ensure that savings are directed to their most productive use. Allocational efficiency demands operational efficiency – investors must be able to transfer their investments cheaply and easily. It also demands external efficiency – prices must rapidly adjust to reflect all available information and the market must be "fair".

Allocational efficiency in *primary* capital markets is what really matters, since it is this market that channels capital from savers to those who will use it to acquire real capital assets, assets that produce goods and services. Efficient *secondary* markets are important because they furnish a pricing function and establish costs of capital to users of capital. They are important, too, because they furnish the mechanism by which investors can transfer investments and are therefore encouraged to supply capital in the primary market.

Tests of external efficiency have indicated that the United States stock market is quite efficient and that the same is true of the Canadian stock market, except for mining and oil stocks. It is

not clear that any changes in the mining and oil stock market are called for, however.

Operational efficiency in the U.S. stock market has benefitted from competition – in the form of an over-the-counter market competing with the exchanges in the trading of listed stocks, and in commission rate competition on the exchanges since rates were unfixed in 1975. There is a difference of opinion as to which of dealer markets or agent markets is the better. Either form is compatible with a continuous auction market. The need for *some* dealer activity in listed stocks has been grudgingly admitted by stock exchanges in both Canada and the United States. The specialist on the New York Stock Exchange and the registered trader on the Toronto Stock Exchange deal for their own accounts and are necessary to provide price continuity and depth for the benefit of investors who trade modest quantities of stock.

Neither the specialist nor the registered trader is expected to provide market depth to institutions trading large blocks of stock. Yet institutions have become an important part of the market.[123] Block positioning, or liability trading, in large blocks has become well accepted in the United States as a necessary adjunct to agency trading. In Canada, there has been less willingness to permit this kind of accommodation to institutions and as a result there has been some loss of business to United States markets. Although the Toronto Stock Exchange has been relaxing its limitations on liability trading in recent years the Canadian securities industry still does not offer to institutions the facilities for buying and selling large blocks that can be found in the United States. This is the result of rules imposed by the industry, rules that are subject to regulatory oversight.

Rather little research has been carried out on the operational efficiency of Canadian secondary markets. What has been done suggests a lower level of efficiency than is found in the United States.

As far as the primary capital market is concerned, some U.S. research has cast doubt on allocational efficiency in that country. The difficulties seem to originate in underwriting arrangements, however, rather than in the mechanism of the market. The Canadian primary capital market seems about as efficient as the U.S. market. There is some evidence that the costs of new issues in Canada are more likely to be reflected in direct charges by underwriters while those in the U.S. are more likely to take the form of underpricing.

123 Their importance, relative to that of individuals, is dealt with in some detail in *Williamson, Financial Institutions*, especially ch. V.

Whether government-enforced disclosure requirements actually add to market efficiency has been debated in the United States. The benefits of the availability of information must be balanced against the costs and delays imposed on issuers. Canadian data indicate that at least for mining and industrial offerings to the public delays have not been increasing in recent years.

Information supplied through broker research is considered by many investors, including many Canadian institutions, as an important contributor to efficiency. Some institutions, however, have indicated that there is a good deal of low quality, redundant research being produced. Experience in the United States suggests that the unfixing of commission rates might reduce the duplication and raise the average quality of research. Empirical analysis of broker research, however, has suggested that it is generally not of much value.

The provision of broker research to institutions is bound up with commission arrangements and the United States experience suggests that a shift to competitive rates requires careful consideration of the arrangements that have developed and perhaps some legislation or rule-making to bring about a smooth transition to new arrangements.

Recent years have shown opportunities for the use of imagination and ingenuity in developing new instruments and new market mechanisms to improve capital markets or parts of them. A regulatory commission that has a concern for the economy will want to keep track of these innovations, take advantage of what analysis has been done of their operations and economic effects, undertake or encourage further analysis, and determine whether or how they are to be brought under the regulatory system. In recent years innovation has almost all come from abroad but there is no obvious reason why this should continue.

Chapter III
Rates of Return on Stocks and Bonds

One test of the quality of a capital market or securities market is the performance of that market in terms of rate of return achieved by investors. If the market has been extraordinarily profitable over an extended period of time, then there is probably some lack of efficiency, some failure in the marketplace to channel savings into investment and therefore an inadequate flow of capital to those who could use it productively. And if the market has been extraordinarily unprofitable to investors over a long period, then once again the market is functioning poorly, this time

to channel savings into unproductive uses and to prevent investors from finding productive uses.

A more refined test of market quality goes to differentials in rates of return, particularly the difference between investor experience in stocks and bonds. Bonds should, in the long run, be less profitable than stocks. And the difference should reflect the greater safety of bonds. It may reflect other factors as well, such as tax rules differentiating stock investment from bond investment.

Differences in investor rates of return between stocks and bonds is a measure of the difference in cost, to a business corporation, between equity and debt. And this difference in cost gives some insights into the corporation's choice between equity and debt financing. This choice is a subject that has given rise to considerable concern in North America, with business groups and representatives of the securities industry arguing for government interference to shift that choice in favour of equity financing.

Whether interference is called for or whether the cost differential as it exists is enough to bring about a reasonable balance is something that we can try to establish from a study of rates of return.

A. HISTORICAL COMPARISONS

There have been two major studies in the United States of long-run rates of return in the securities markets. The first, undertaken at the University of Chicago by Lawrence Fisher and James Lorie, examined rates of return on all stocks listed on the New York Stock Exchange from 1926 through 1965.[124] The most notable feature of that study was the compound average rate of return of 9.3% a year that an investor would have experienced holding all the stocks listed on the New York Stock Exchange over the 1926 to 1965 period and reinvesting all his dividends in those stocks. The Fisher and Lorie study was followed up in 1975 by a broader study, also conducted at the University of Chicago, by Roger Ibbotson and Rex Sinquefield. This study examined rates of return on common stocks, treasury bills, long-term United States government bonds and long-term corporate bonds for the period 1926 through 1974.[125] These series have subsequently been extended through 1976.[126]

124 Fisher & Lorie, *Rates of Return on Investments in Common Stock: The Year-By-Year Record, 1926-65*, 41 J. Bus. 291 (July 1968).

125 Ibbotson & Sinquefield, *Stocks, Bond, Bills and Inflation: Year-By-Year Historical Returns (1926-1974)*, 49 J. Bus. 11 (January 1976).

126 Stocks, Bonds, Bills and Inflation: The Past (1926-1976) and the Future (1977-2000) (Financial Analysts Research Foundation Monograph 1977).

The Ibbotson and Sinquefield study has made it possible to compare, for the United States securities markets, long-run rates of return on stocks, bonds and treasury bills. In addition to calculating rates of return on these different securities, Ibbotson and Sinquefield also calculated variability in the rates of return in the form of standard deviations of return. And they used the consumer price index to put all of the returns in "real", or deflated, terms. If we take the standard deviation in returns as a risk measure, which most of the theoretical literature now does, we can examine the Ibbotson and Sinquefield results to see whether the securities marketplace has been efficient – that is, whether the rates of return on the various securities have been proportional to the risk in those securities. Table 15 summarizes the 1926–76 results of the Ibbotson and Sinquefield study. The geometric or compound average rate of return is the best guide to the long-run performance of the instrument in question. But it is the arithmetic mean of the fifty-one rates of return that one might expect to be correlated with the standard deviation in an efficient market. Figure 5 shows a plot of the arithmetic average rate of return against standard deviation. The relationship is not perfect but it is fairly close. The same is true for "real" rates – that is, rates adjusted for inflation.

It is possible to approximate the Ibbotson and Sinquefield study for securities markets in Canada using the series published monthly by the Bank of Canada and Toronto Stock Exchange index data. Table 16 shows the year-end consumer price index and year-end wealth relatives for the Toronto Stock Exchange composite index, long Canadian government bonds, ten provincial bonds, ten municipal bonds, and ten industrial bonds (these three are tabulated by McLeod Young Weir), treasury bills and bankers' acceptances. The wealth relative is based on a value of 100 at the beginning of the first year for which a series is tabulated.[127] The investor who started with a $100 investment and reinvested all his dividends or interest would have at each year end the amounts shown in the columns in table 16. For example, $100 invested at the end of 1933 in the Toronto Stock Exchange index would have grown to $3,501.61 by the end of 1976. From these wealth relatives it is easy to calculate a compound average rate of return for any of the securities over any time period for which data are available.

Table 17 corresponds to table 16, with all the wealth relatives adjusted for inflation. For example, $100 invested at the end of 1933 in the Toronto Stock Exchange index would have grown, with the reinvestment of all dividends, to have the purchasing power at the end of 1976 of $784.25 in 1933 dollars.

127 Details of the calculations are described in the appendix to this paper.

Table 15
Nominal and Real Average Annual Rates of Return for U.S. Securities Markets

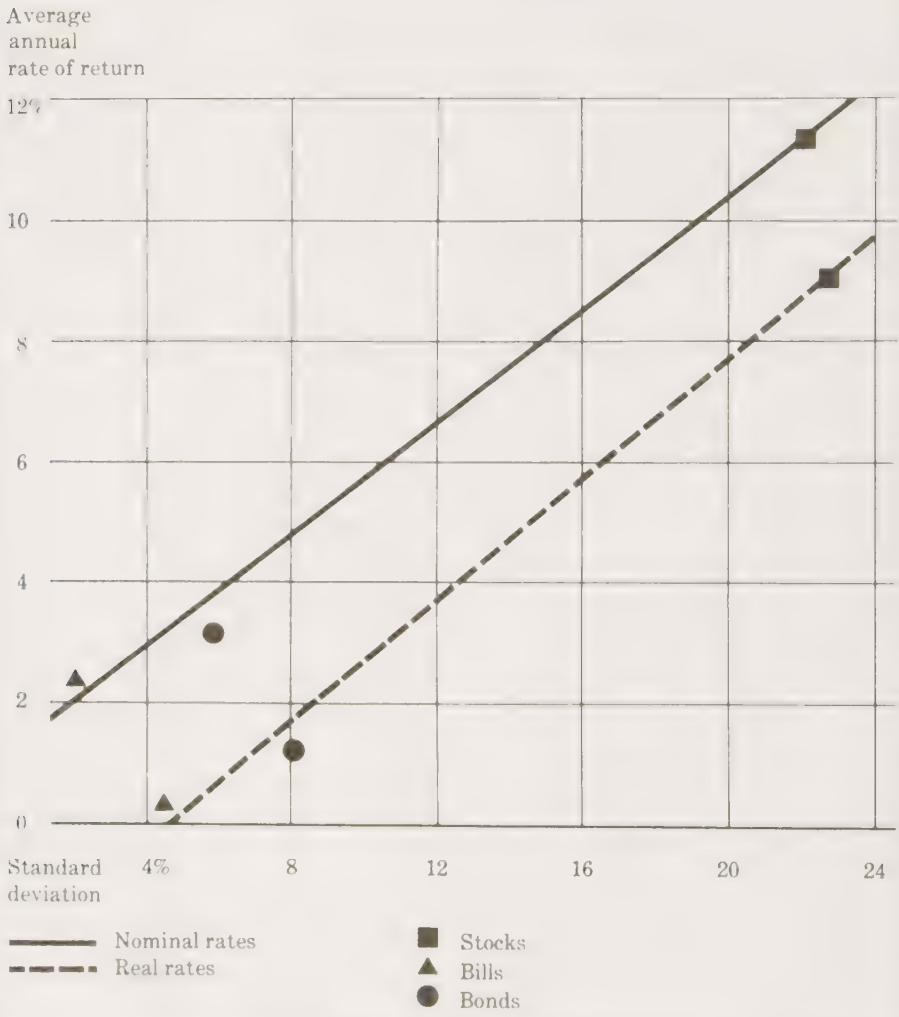
1926–76

	Geometric average	Arithmetic average	Standard deviation
Nominal average annual rates			
Inflation	2.34%	2.44%	4.70%
Stocks	9.24	11.63	22.21
Government bonds	3.38	3.53	5.71
Treasury bills	2.37	2.40	2.12
Real average annual rates			
Stocks	6.74	9.19	22.42
Government bonds	1.02	1.33	7.99
Treasury bills	0.04	0.14	4.51

Table 16
Index of Canadian Wealth Relatives
1933–76

	Consumer price index	TSE stocks	Canadian Government bonds	Provincial bonds	Municipal bonds	Industrial bonds	Treasury bills	Bankers' acceptances
1933	34.20	100.00					100.00	
1934	34.60	94.16					101.05	
1935	35.30	118.85	100.00				102.11	
1936	35.80	154.78	103.24				103.06	
1937	37.10	117.51	102.62				103.80	
1938	36.50	126.63	108.44				104.44	
1939	37.50	133.05	104.80				105.15	
1940	39.00	108.52	114.09				105.93	
1941	41.80	102.63	118.46				106.55	
1942	43.00	112.55	122.12				107.13	
1943	43.50	137.44	126.86				107.67	
1944	43.10	159.16	130.87				108.09	
1945	43.70	222.56	137.77				108.48	
1946	46.30	230.25	146.06				108.90	
1947	53.00	226.33	150.70	100.00	100.00	100.00	109.34	
1948	57.70	246.94	147.18	101.77	99.54	101.92	109.79	
1949	58.30	291.47	154.43	107.17	103.65	106.99	110.30	
1950	61.90	419.87	154.04	106.97	107.12	109.75	110.89	
1951	68.50	509.38	149.00	97.99	95.40	102.23	111.71	
1952	67.20	495.44	151.92	102.83	101.70	106.78	112.83	
1953	67.20	494.60	157.59	108.22	107.79	110.95	114.65	
1954	67.60	673.50	173.39	123.16	123.12	122.68	116.45	
1955	67.90	850.62	172.36	119.56	123.07	125.22	118.05	
1956	69.90	976.09	165.75	107.27	108.67	115.12	121.30	
1957	71.50	774.41	176.78	118.56	119.10	123.86	125.92	
1958	73.30	1018.20	165.84	116.50	121.59	127.39	128.80	
1959	74.20	1063.27	157.89	110.26	112.81	121.44	134.70	
1960	75.20	1080.91	168.74	122.31	127.94	136.12	139.47	
1961	75.40	1432.55	185.36	133.83	142.12	148.31	143.48	
1962	76.60	1328.60	190.99	139.93	149.21	155.52	149.13	
1963	77.90	1535.24	199.62	146.10	156.19	163.78	154.52	100.00
1964	79.40	1923.61	213.06	156.41	167.03	171.34	160.36	103.75
1965	81.70	2049.29	214.87	156.42	167.97	169.87	166.61	108.12
1966	84.70	1903.65	218.15	153.86	166.14	166.70	174.92	114.13
1967	88.10	2246.14	212.53	153.59	163.73	165.61	182.84	120.40
1968	91.70	2748.17	210.58	155.58	166.86	169.17	194.38	128.62
1969	95.90	2721.73	204.85	150.44	158.75	166.75	208.09	138.72
1970	97.30	2623.58	251.85	178.79	188.91	189.92	221.94	149.17
1971	102.20	2835.02	281.61	202.59	222.18	217.37	230.38	155.88
1972	107.50	3609.28	285.34	216.02	233.66	237.76	238.48	163.68
1973	117.30	3611.64	290.19	217.81	239.08	243.17	250.60	175.47
1974	131.80	2666.00	286.21	212.15	228.59	228.22	270.24	194.14
1975	144.30	3156.55	293.16	226.75	244.30	246.61	289.88	209.66
1976	152.70	3501.61	350.87	274.57	304.80	301.48	316.41	229.74

Figure 5
Average Annual Rate of Return and Standard Deviation
U.S. Data 1926–76



The Canadian data do not go back to 1926 and indeed to push the Toronto Stock Exchange index back before 1956 it is necessary to splice the present index series to an old series.[128] Table 18 is based on the time period 1937–76 for which it is possible to use the Toronto Stock Exchange index and the Bank of Canada series for Canadian government bonds and treasury bills. For comparison purposes, United States statistics from the Ibbotson and Sinquefield study have been computed for the same 1937–76 period. The average rates of return and the standard deviations have also been computed in "real" terms, deflated by the appropriate consumer price index. The relationships between the arithmetic average rates of return and standard deviations in table 18 have been plotted on figure 6. As in figure 5, figure 6 shows an approximately linear relationship between rate of return and standard deviation. In terms of a risk-return tradeoff, it appears that stocks and treasury bills have done a little better than long government bonds over the forty-year period.

A comparison of tables 15 and 18 shows substantial consistency between fifty-one year and forty-year performances of stocks in the United States, with less consistency in the performances of government bonds and treasury bills. This provides some reassurance that the Canadian data for common stocks for forty years, in table 18, have some value as a guide to probable long-run performance.

B. EQUITY VERSUS DEBT FINANCING

Recent years have seen many appeals, in both Canada and the United States, for greater encouragement to industry to finance with equity as opposed to debt. It has been argued that the proportion of debt in corporate capital structures has been rising and is now dangerously high.[129] If this is the case, then it means that the cost of equity financing is excessive compared to the cost of debt so that corporations are induced to rely excessively on debt. The data we have just examined can be used to see whether this is the case.

One would expect prices of stocks, bonds and other investment opportunities to adjust in the marketplace until all appear to offer about the same risk-return tradeoff to investors. The high-risk investments will offer the expectation of high rates of return

128 The old and new indexes are described in the appendix to this paper.

129 *See e.g.* letter from the president of the Toronto Stock Exchange to the Minister of Finance (September 13, 1976); and accompanying it, TSE, STUDY AS TO THE CONTINUING SIGNIFICANCE OF EQUITIES IN THE CANADIAN CAPITAL MARKETS (1976).

Table I7
Index of Canadian Wealth Relatives Adjusted for Inflation

1933–76

	TSE stocks	Canadian government bonds	Provincial bonds	Municipal bonds	Industrial bonds	Treasury bills	Bankers acceptances
1933	100.00					100.00	
1934	93.07					99.88	
1935	115.15	100.00				98.93	
1936	147.86	101.80				98.45	
1937	108.32	97.64				95.69	
1938	118.65	104.87				97.86	
1939	121.34	98.65				95.90	
1940	95.16	103.27				92.89	
1941	83.97	100.04				87.18	
1942	89.52	100.25				85.21	
1943	108.06	102.95				84.65	
1944	126.29	107.19				85.77	
1945	174.18	111.29				84.90	
1946	170.08	111.36				80.44	
1947	146.05	100.37	100.00	100.00	100.00	70.56	
1948	146.37	90.04	93.48	91.43	93.62	65.07	
1949	170.98	93.51	97.43	94.23	97.26	64.70	
1950	231.98	87.85	91.59	91.72	93.97	61.27	
1951	254.32	76.78	75.82	73.81	79.10	55.77	
1952	252.14	79.80	81.10	80.21	84.22	57.42	
1953	251.72	82.78	85.35	85.01	87.51	58.35	
1954	340.74	90.54	96.56	96.53	96.18	58.91	
1955	428.44	89.61	93.32	96.06	97.74	59.46	
1956	477.57	83.70	81.33	82.40	87.29	59.35	
1957	370.42	87.28	87.88	88.28	91.81	60.23	
1958	475.07	79.87	84.24	87.92	92.11	60.09	
1959	490.08	75.11	78.76	80.58	86.74	62.09	
1960	491.58	79.21	86.20	90.17	95.94	63.43	
1961	649.78	86.78	94.07	99.90	104.25	65.08	
1962	593.19	88.01	96.82	103.24	107.61	66.58	
1963	674.01	90.46	99.40	106.27	111.43	67.84	100.00
1964	828.56	94.72	104.40	111.49	114.37	69.07	101.79
1965	857.84	92.84	101.47	108.96	110.20	69.74	103.09
1966	768.65	90.92	96.28	103.96	104.31	70.63	104.97
1967	871.94	85.16	92.40	98.50	99.63	70.98	106.46
1968	1024.94	81.06	89.92	96.44	97.78	72.50	109.26
1969	970.63	75.40	83.14	87.73	92.16	74.21	112.68
1970	922.16	91.37	97.39	102.90	103.45	78.01	119.43

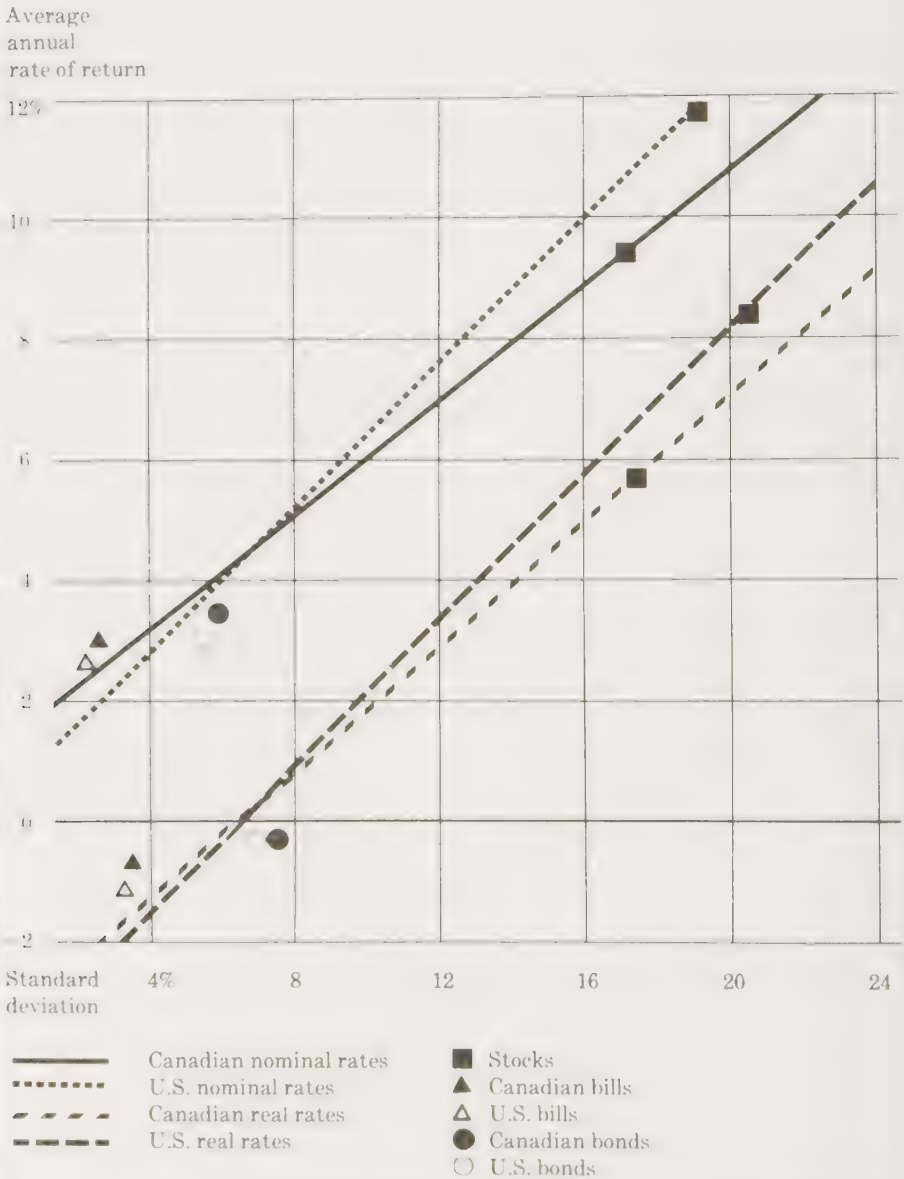
	TSE stocks	Canadian government bonds	Provincial bonds	Municipal bonds	Industrial bonds	Treasury bills	Bankers' acceptances
1971	948.71	97.27	105.06	115.22	112.73	77.09	118.82
1972	1148.25	93.70	106.50	115.20	117.22	75.87	118.61
1973	1053.01	87.33	98.41	108.02	109.87	73.06	116.53
1974	691.78	76.66	85.31	91.92	91.77	70.12	114.75
1975	748.12	71.72	83.28	89.73	90.58	68.70	113.18
1976	784.25	81.11	95.30	105.79	104.64	70.87	117.20

Table 18
Comparison of U.S. and Canadian Securities Markets Performance

1937–76

	Canada			U.S.		
	Geometric average	Arithmetic average	Standard deviation	Geometric average	Arithmetic average	Standard deviation
Nominal rates						
Inflation	3.69%	3.76%	3.68%	3.63%	3.70%	3.96%
Stocks	8.11	9.44	16.77	9.54	11.28	19.07
Government bonds	3.11	3.27	5.92	2.88	3.03	5.61
Treasury bills	2.84	2.87	2.45	2.54	2.56	2.21
Real rates						
Stocks	4.26	5.72	17.16	5.70	7.70	20.06
Government bonds	−0.57	−0.31	7.18	−0.72	−0.48	6.95
Treasury bills	−0.82	−0.75	3.66	−1.05	−0.98	3.61

Figure 6
Relationship between Return and Risk
1937–76



and the low-risk investments the expectation of a low rate of return.

The differential between expected returns on common stocks and expected returns on bonds will be a measure of the difference in risk that investors associate with the two. If the differential is high then investors are expressing great concern about the riskiness of common stocks and equity financing will be very expensive for industry compared to debt financing.

It is impossible to measure directly the rates of return investors *expect* from stocks, bonds and other investments, so we are forced to look at what they have actually obtained from these investments and to reason that over long periods of time, experience will mold expectations and therefore provide a fair representation of their expectations. And in fact, the Ibbotson and Sinquefield numbers described above *have* had a significant impact on the expectations of institutional investors in the United States.

Table 19 shows average rates of return achieved over ten-year periods on stocks, and on government bonds in Canada and the United States. The United States figures are computed from the Ibbotson and Sinquefield data and the Canadian figures from the Canadian data described above and represent average annual rates of return over the decades indicated, including both price appreciation and dividend or interest income.

Figure 7 shows the rate differentials from table 19. Until the stock market decline of 1973–74, the differential in the United States was generally higher than that in Canada – on the order of 1-1/2% to 2% higher. So apparently U. S. investors saw greater relative risk (relative to bonds) in U.S. common stocks than Canadian investors saw in Canadian stocks. And equity financing was therefore relatively cheaper in Canada. The choice facing an industrial corporation, of course, is not between stock and government bonds but between stock and corporate bonds, but the differentials between returns on stocks and on corporate bonds show relationships similar to those between stock and government bond returns. Table 20 is based on data for the McLeod Young Weir index of ten Canadian industrial bonds and the Ibbotson and Sinquefield data for long-term United States corporate bonds. Figure 8 shows the differentials from table 20.

For the decades ending in 1973 through 1975 the relationship reversed, but in 1976 it changed back again and Canadian companies once again appear to benefit from a lower differential between the cost of equity and cost of debt.

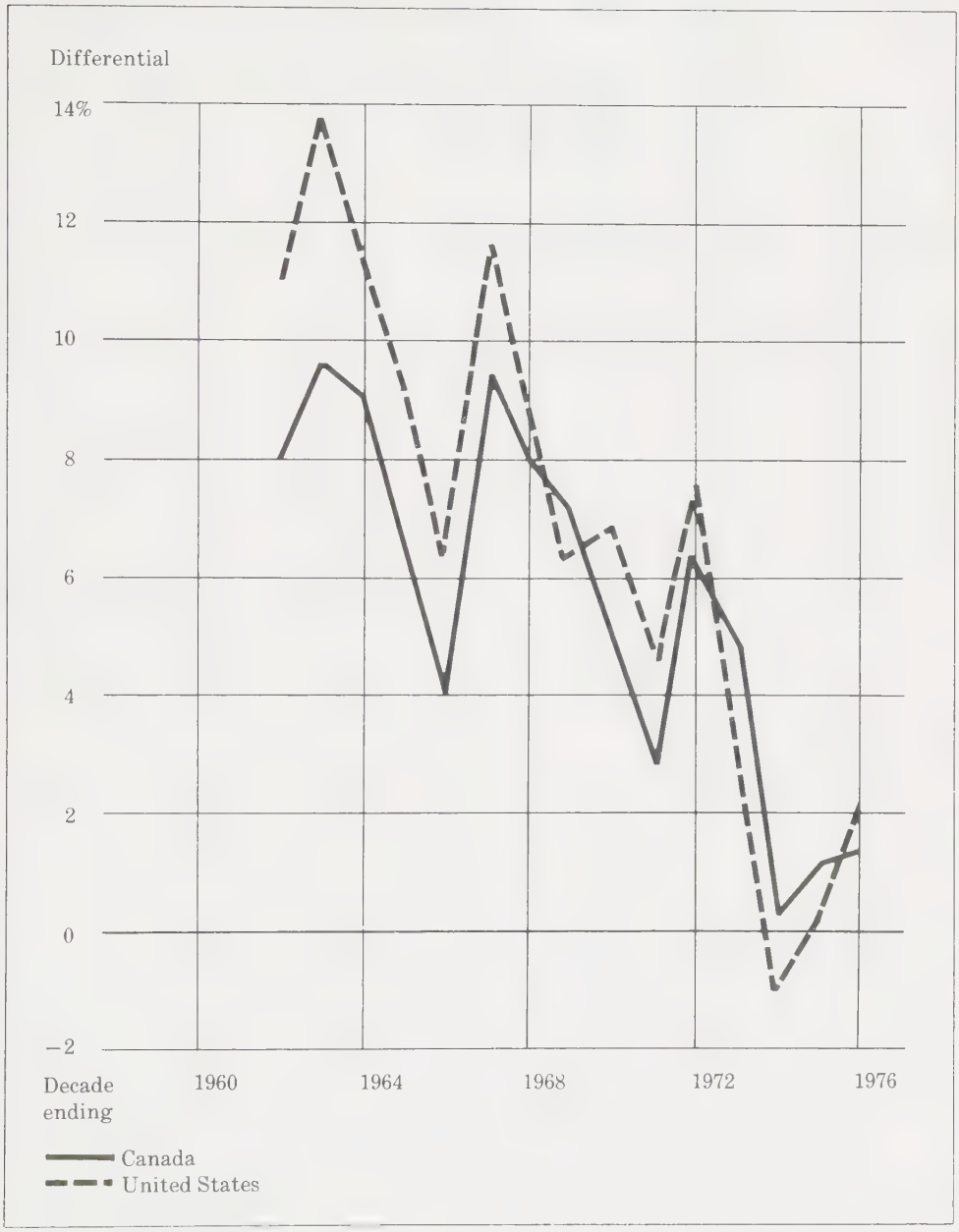
Figure 9 shows the rates of return on stocks and bonds from table 19. Canadian government bonds have fairly consistently produced higher rates of return than United States government

Table 19
Comparison of Average Annual Nominal Rates of Return of Common Stocks and Government Bonds between U.S. and Canada

Decades ending December 31, 1962–76

	Canada			U.S.		
	Common stocks	Government bonds	Differential	Common stocks	Government bonds	Differential
1962	10.37%	2.32%	8.05%	13.44%	2.29%	11.15%
1963	11.99	2.39	9.60	15.91	2.04	13.87
1964	11.07	2.08	8.98	12.82	1.69	11.13
1965	9.19	2.23	6.96	11.06	1.89	9.17
1966	6.91	2.79	4.12	9.20	2.85	6.35
1967	11.24	1.86	9.38	12.85	1.13	11.72
1968	10.44	2.42	8.02	10.00	1.74	8.26
1969	9.86	2.64	7.22	7.81	1.44	6.36
1970	9.27	4.09	5.19	8.18	1.30	6.88
1971	7.06	4.27	2.79	7.06	2.47	4.59
1972	10.51	4.10	6.41	9.93	2.35	7.59
1973	8.93	3.81	5.12	6.00	2.11	3.89
1974	3.32	3.00	0.32	1.24	2.19	−0.96
1975	4.41	3.16	1.26	3.27	3.02	0.25
1976	6.28	4.87	1.42	6.63	4.26	2.37
Average	8.72	3.07	5.66	9.03	2.19	6.84

Figure 7
Comparison between Canada and U.S. Differentials between Average Annual Rates of Return on Stocks and Government Bonds



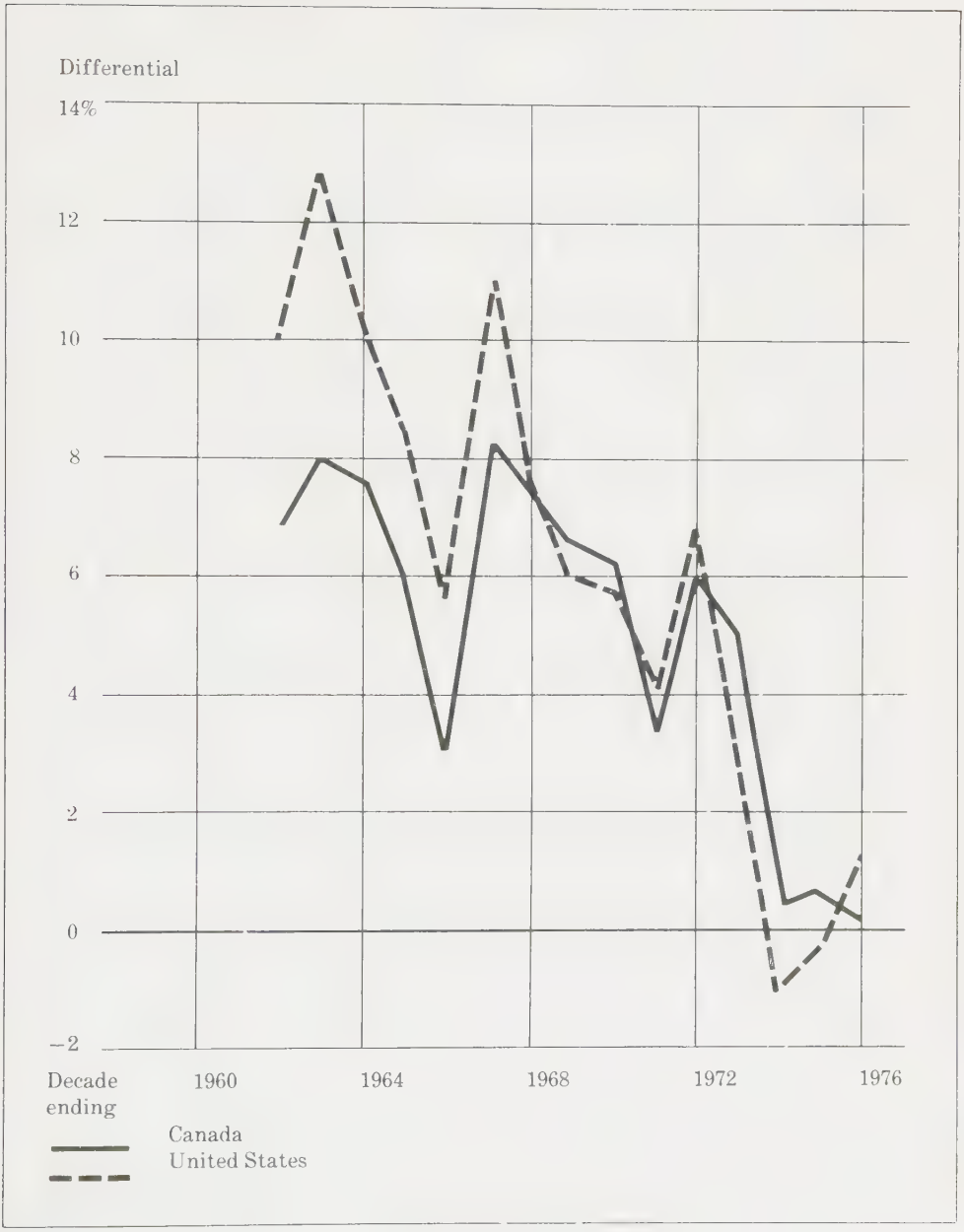
Source: Data in table 19.

Table 20
Comparison of Average Annual Nominal Rates of Return of Common Stocks and Corporate Bonds between U.S. and Canada

Decades ending December 31, 1962–76

	Canada			U.S.		
	Common stocks	Industrial bonds	Differential	Common stocks	Corporate bonds	Differential
1962	10.37%	3.83%	6.54%	13.44%	2.86%	10.58%
1963	11.99	3.97	8.02	15.91	2.74	13.17
1964	11.07	3.40	7.67	12.82	2.68	10.15
1965	9.19	3.10	6.09	11.06	2.58	8.48
1966	6.91	3.77	3.14	9.20	3.30	5.89
1967	11.24	2.95	8.29	12.85	1.95	10.90
1968	10.44	2.88	7.56	10.00	2.44	7.57
1969	9.86	3.22	6.63	7.81	1.68	6.13
1970	9.27	3.39	5.89	8.18	2.51	5.67
1971	7.06	3.90	3.17	7.06	3.10	3.95
1972	10.51	4.34	6.17	9.93	3.04	6.89
1973	8.93	4.03	4.90	6.00	2.93	3.07
1974	3.32	2.91	0.41	1.24	2.13	−0.90
1975	4.41	3.80	0.62	3.27	3.59	−0.31
1976	6.28	6.10	0.18	6.63	5.38	1.25
Average	8.72	3.71	5.02	9.03	2.86	6.17

Figure 8
Comparison between Canada and U.S. Differentials between Average Annual Rates of Return on Stocks and Corporate Bonds



Source: Data in table 20.

bonds. Canadian stocks generally provided lower returns than U.S. stocks for the decades ending before 1968. Since then, until the decade ending in 1976, Canadian returns have been higher. It is possible that the experience since 1968 has been affected by a repatriation of foreign investments by Canadian pension funds. In 1969 the Canadian government first announced the 10% limitation on foreign investment by Canadian pension funds, a limitation that went into effect in 1971.

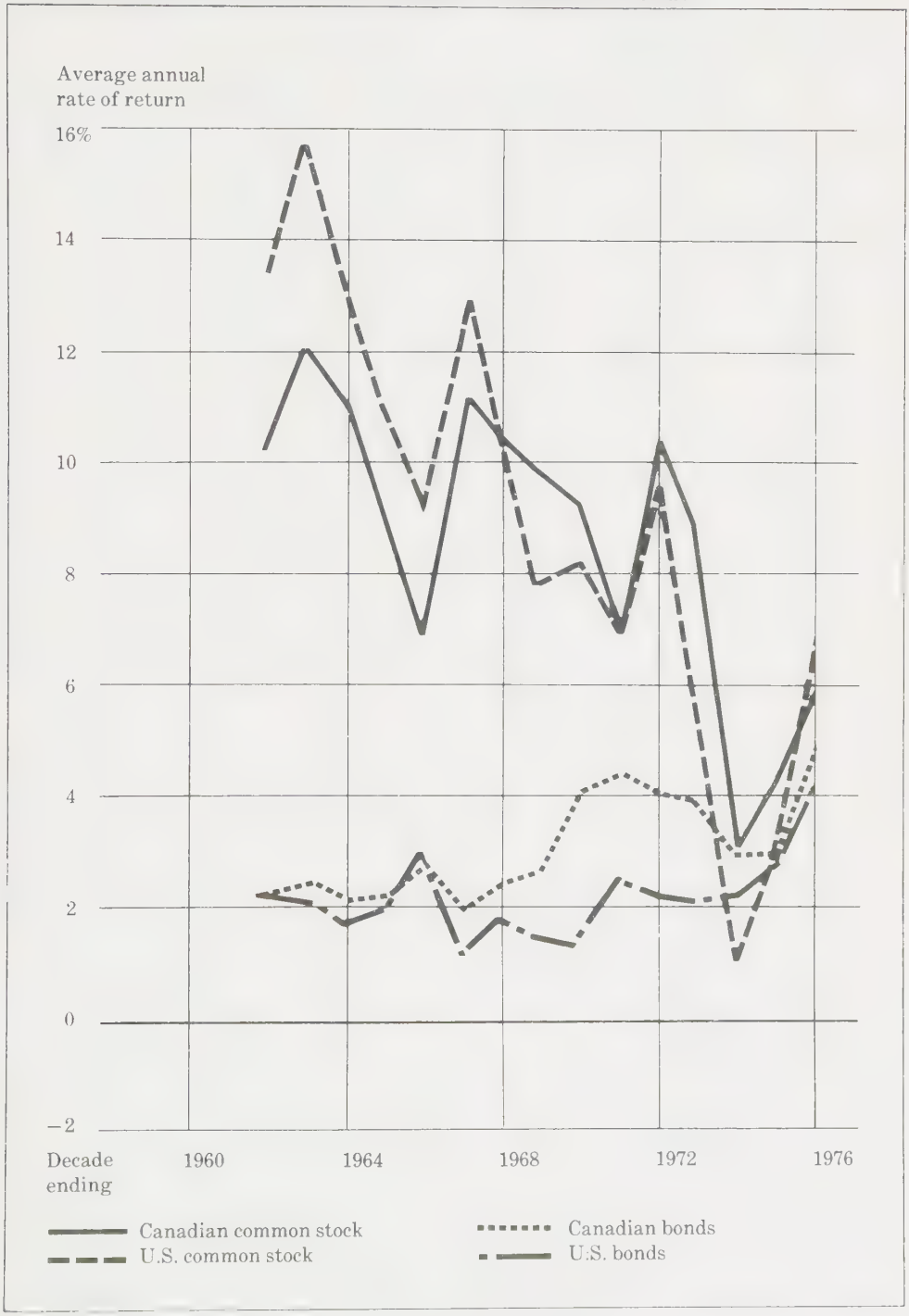
With the exception of the 1969–75 period, then, it appears that investors in Canadian stocks have been satisfied with lower rates of return than those achieved in U.S. stocks. This satisfaction could be because Canadian stocks appeared less risky. At least two studies have concluded that the history of stock performance in the United States and Canada, *after allowing* for risk, shows the former to have been the better one for investors.[130] In both cases the analyses were directed at identifying the benefits of international diversification – there is a good deal of evidence that a portfolio diversified across national boundaries offers better risk-return characteristics than one restricted to a single country. But it appeared that portfolios restricted to U.S. stocks offered better risk-return combinations than those combining Canadian and U.S. stocks. The second of the two studies was concerned chiefly with portfolios diversified across Canadian, Belgian, French, Italian, Japanese, South African, German and British stocks and found that Canadian stocks showed up in "efficiently" diversified portfolios only for conservative, that is, low-risk, low-return, portfolios.

So far, all of this discussion suggests that the Canadian equity market has been a rather poor one for investors (and an attractive one for issuers). But the comparisons have ignored taxes, and the Findlay and Smith study pointed out that the Canadian tax treatment of an individual's dividend receipts may make the Canadian stock market as attractive to Canadians as any other on an after-tax basis. (The analyses certainly indicated that a tax exempt investor was better off in non-Canadian equity markets.) We examined some of the tax factors in chapter I.

This reasoning in turn suggests that the Canadian equity market is segmented from the rest of the world and should depend very much on Canadian investors, without much expectation of attracting substantial foreign investment. United States government bonds, on the other hand, have been relatively more attrac-

130 Smith & Khoury, *Effective Diversification by Canadian and United States Mutual Funds*, 4 J. Bus. Admin. 43 (spring 1973); Findlay & Smith, *Some Canadian Implications of International Portfolio Diversification*, [1976] Fin. Rev. 36.

Figure 9
Comparison between Canada and U.S.
Rates of Return on Common Stocks and Government Bonds



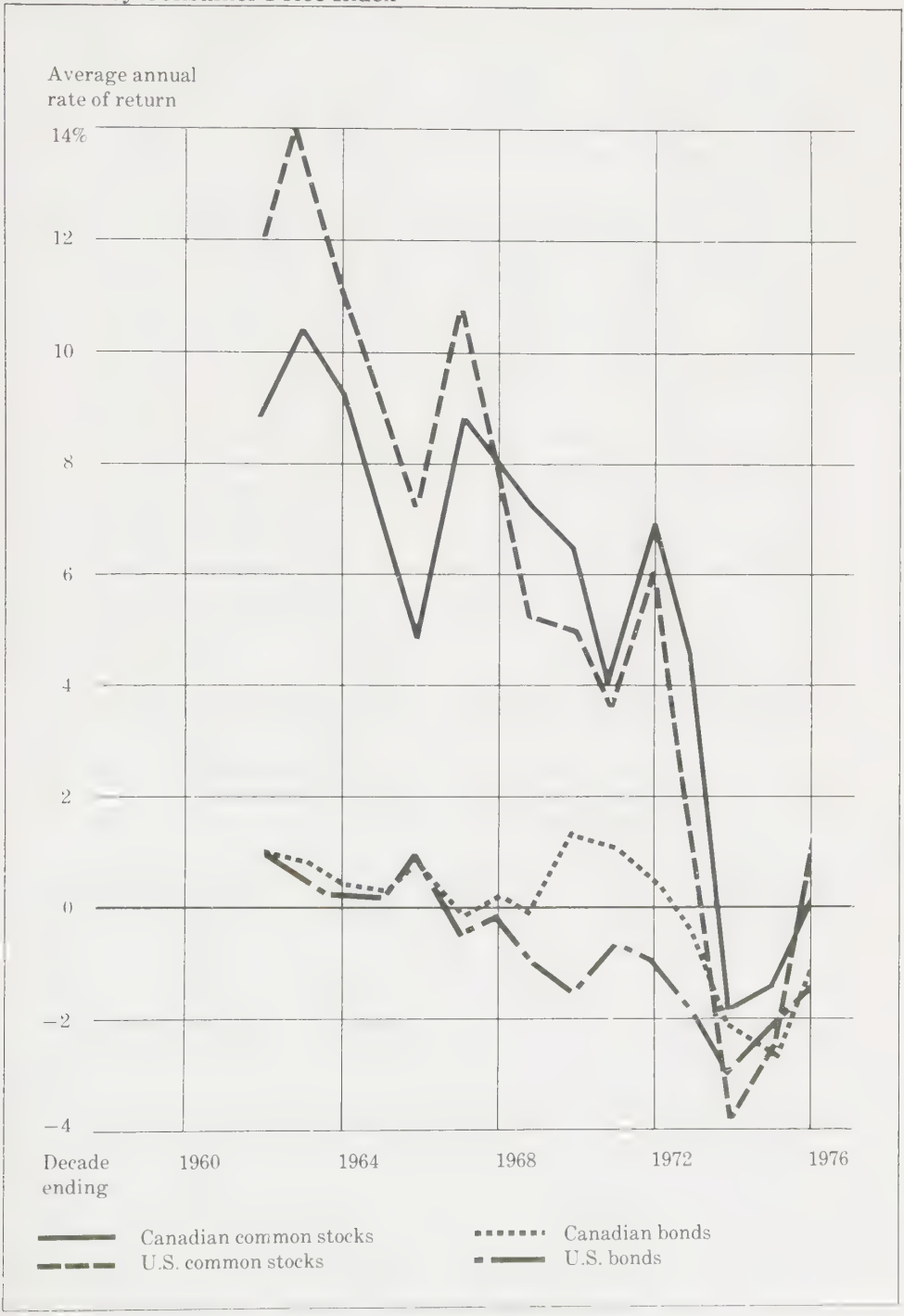
Source: Data in table 19.

Table 21
Comparison of Average Annual Real Rates of Return of Common Stocks and Government Bonds between U.S. and Canada, Deflated by Consumer Price Index

Decades ending December 31, 1962–76

	Canada			U.S.		
	Common stocks	Government bonds	Differential	Common stocks	Government bonds	Differential
1962	8.93%	0.98%	7.95%	11.99%	0.98%	11.01%
1963	10.35	0.89	9.46	14.31	0.63	13.68
1964	9.29	0.45	8.84	11.08	0.12	10.96
1965	7.19	0.35	6.83	9.18	0.16	9.01
1966	4.87	0.83	4.04	7.29	1.06	6.24
1967	8.94	−0.25	9.18	10.88	−0.63	11.51
1968	7.99	0.15	7.84	7.78	−0.32	8.10
1969	7.07	0.04	7.03	5.16	−1.05	6.21
1970	6.49	1.44	5.05	5.11	−1.58	6.69
1971	3.86	1.15	2.71	3.75	−0.70	4.45
1972	6.83	0.63	6.20	6.30	−1.03	7.34
1973	4.56	−0.35	4.91	1.81	−1.93	3.74
1974	−1.79	−2.09	0.31	−3.77	−2.86	−0.91
1975	−1.36	−2.55	1.19	−2.31	−2.54	0.23
1976	0.20	−1.13	1.34	0.72	−1.52	2.24
Average	5.56	0.04	5.53	5.95	−0.75	6.70

Figure 10
Comparison between Canada and U.S. Rates of Return on Common Stocks and Government Bonds, Deflated by Consumer Price Index



Source: Data from table 21.

tive to investors than have Canadian government bonds and the investors have been willing to accept lower interest rates. Very likely the explanation is a lower perceived risk in the United States, coupled with legal requirements making these bonds either more attractive or obligatory for many U.S. institutions. Figure 9 suggests that these Canada-U.S. differences may have declined in recent years, and there may be little difference in costs of financing between the two countries now.

Table 19 was limited to nominal rates of return, unadjusted for inflation. Differences between inflation rates in the two countries could explain some differences between rates of return. Table 21 and figure 10 show stock and bond rates of return adjusted to eliminate inflation. The differences between the two countries are smaller but the pattern remains the same. Table 22 corresponds to table 20, after adjustment to eliminate inflation.

C. CONCLUSIONS AND POLICY IMPLICATIONS

One measure of efficiency in securities markets is the relationship between risk and return for different kinds of securities. The historical evidence for Canada, as well as for the United States, suggests that stocks, bonds and treasury bills have been appropriately priced relative to each other. Compared to the United States securities market the Canadian market has been characterized by relatively low rates of return on equities and high rates of return on fixed income securities. Put another way, Canadian corporations have found the cost of equity to be lower, compared to the cost of debt, than have corporations in the United States.

All of this should be reassuring in view of concern that there should be more equity financing of Canadian corporations. It may be that the welfare of the economy calls for even further narrowing of the gap between the cost of equity and the cost of debt. And this could be accomplished through tax changes. But there is certainly no evidence that the markets are not working well.

If it is true that the Canadian stock market offers competitive rates of return (competitive with foreign markets) to tax-paying Canadian investors but noncompetitive rates to tax-exempt investors such as pension funds, then there may be difficulties ahead. A continuing shift of investment from direct individual holding of shares to intermediation through pension funds will weaken the appeal of Canadian equities, unless the tax-exempt funds are *forced* to buy them. As we have seen, they are prevented by law from buying foreign equities. A further step might be to limit their investment in Canadian fixed income securities. This kind of

Table 22
Comparison of Average Annual Real Rates of Return of Common Stocks and Corporate Bonds between U.S. and Canada, Deflated by Consumer Price Index

Decades ending December 31, 1962–76

	Canada			U.S.		
	Common stocks	Industrial bonds	Differential	Common stocks	Corporate bonds	Differential
1962	8.93%	2.48%	6.45%	11.99%	1.54%	10.45%
1963	10.35	2.45	7.90	14.31	1.32	12.99
1964	9.29	1.75	7.55	11.08	1.09	9.99
1965	7.19	1.21	5.98	9.18	0.84	8.34
1966	4.87	1.80	3.08	7.29	1.50	5.79
1967	8.94	0.82	8.12	10.88	0.18	10.71
1968	7.99	0.60	7.39	7.78	0.37	7.41
1969	7.07	0.61	6.47	5.16	−0.82	5.98
1970	6.49	0.76	5.74	5.11	−0.40	5.51
1971	3.86	0.78	3.07	3.75	−0.09	3.83
1972	6.83	0.86	5.97	6.30	−0.36	6.67
1973	4.56	−0.14	4.70	1.81	−1.14	2.95
1974	−1.79	−2.18	0.39	−3.77	−2.92	−0.85
1975	−1.36	−1.94	0.58	−2.31	−2.01	−0.30
1976	0.20	0.03	0.17	0.72	−0.46	1.18
Average	5.56	0.66	4.90	5.95	−0.09	6.04

regimentation is an almost automatic development when rates of return are manipulated, as through tax changes, by governments.

Chapter IV
A National Securities Market

In both the United States and Canada the concept of a single national market in securities, particularly in stocks, is very appealing. Computer facilities can clearly do much to make the operation of a marketplace more efficient and they offer the hope of a unification that has never been achieved in the past.

Operational efficiency, as it was described in chapter II, is an obvious goal of a national system. From a Canadian point of view, meeting the competitive threat of U.S. markets may be another goal. A significant portion of the trading in active Canadian stocks already takes place in the United States, most of it among Americans and other foreigners or in the form of dealer arbitraging. If the U.S. marketplace becomes a more attractive place to trade relative to Canadian markets, it is possible that it could also take over a significant portion of the business generated by Canadians.[131]

Creation of a national marketplace, particularly one in which computerized trading may play a significant part, is bound to meet with some opposition. In both Canada and the United States some elements of the securities industry are likely to suffer a loss of privileges or competitive advantage, although this is much more obvious and is likely to generate much more opposition in the United States than in Canada. In Canada a shift from what is now an unofficially national marketplace dominated by Toronto to a formal national market is likely to add some urgency to questions of federal and provincial jurisdiction. In the United States jurisdiction is not an issue but a serious policy question has emerged concerning a compromise between competition that fosters efficiency and innovation in a marketplace and the public utility kind of monopoly that often seems essential to an efficient, specialized service. This question is not as significant in Canada which does not have the variety of competing marketplaces that can be found in the United States, a variety that could vanish in a single national market. But some policy choices will have to be made, even if they are made by default, concerning access to a national market and the degree of competition within it.

131 This competition is discussed in *Williamson, Financial Institutions*, ch. III.

A. MOVEMENT TOWARDS A NATIONAL MARKET SYSTEM IN THE UNITED STATES

In the Securities Reform Act of 1975 Congress instructed the SEC "to use its authority under this title to facilitate the establishment of a National Market System for securities...to carry out the objectives set forth...". The objectives included economically efficient execution of securities transactions, fair competition among brokers and dealers and markets, availability to brokers, dealers and investors of quotation and transaction information, the practicability of executing orders in the best market, and an opportunity for investors' orders to be executed without the participation of a dealer. Congress was not very specific about how this National Market System was to be constructed but it did call for a National Market Advisory Board to make recommendations to the SEC. The board and the SEC appealed for suggestions.

1. *The Merrill Lynch Proposal of October 1975*

One of the first proposals was put forward by Merrill Lynch in October 1975. It was intended to promote the auction-agency market and was based on three principles: there would be price priority (*i.e.*, securities would be sold to the highest bidder and bought from the lowest offeror), investors would trade with one another without the intervention of a dealer whenever possible, and competition among securities firms including market-making firms would be encouraged. Merrill Lynch expected its model to increase competition, to provide broader access to the broker-dealer and market-making functions, and to attract more firms and more capital to the securities business.[132]

The Merrill Lynch proposals form a good starting point against which to judge subsequent proposals. Some features were relatively noncontroversial. Merrill Lynch assumed that commission rates would remain competitive and that all professional participants in the system would be subject to equal regulation. All would be registered under the Securities Exchange Act, including affiliates of institutions and foreign entities. All transactions of registered broker-dealers or "institutional investors" would have to take place within the National Market System, making them subject to composite tape reporting, a best execution rule, and limit order protection. There would be a single central system communicating quotes to participants in the market. Executions

132 Merrill Lynch, Pierce, Fenner & Smith, Inc., Proposal for a National Market System, annex A, at 2 (October 1975).

would be subject to price priority, time priority, and priority of the public over securities firms.

Limit order protection is an important element in any proposal for a National Market System. An offer to buy or sell a specified number of shares of a particular stock at a specified price is a limit order. Most limit orders sent to a stock exchange in the United States end up on the book of the specialist in the stock. The specialist matches orders to buy and sell at the same price and ensures that an order to buy or sell "at the market" is matched with the best limit order to sell or buy – the lowest priced sell order or highest priced buy order. All of this means that the investor who places an order to buy at a specified price can be assured that no one else will buy for less until his order is filled. And one who places an order to sell at a specified price can be assured that no one else will sell for more.

It is fairly easy to maintain limit order protection on the floor of an exchange. It is much more difficult to maintain it throughout a larger marketplace, one that includes several exchanges and an over-the-counter market.

The controversial aspects of the proposal were concerned with the market-making function and the quotation system. Merrill Lynch proposed that all bids and offers with accompanying price and size would have to be entered in the National Market System electronic "book" without identification of the source. The entire book would be available for viewing by any market-maker, and by any other member of the system with a "need to know" but not by the public. A broker with a "need to know" would be a broker wanting to make a transaction in a particular security and he would be allowed to see the book for that security.

All quotations in the book would be available to be "hit". Those with access to the book could then complete a transaction simply by signalling acceptance of a quotation.

There would be no limit on the number of market-makers in a stock. Exchanges would be free to impose limitations on market-making on their floors but they would not be able to limit off-board market-making. No market-maker would have any *obligation* to "make a market" but, to discourage in-and-out market-making, a market-maker would have to make a commitment for perhaps six months to provide two sides in given size for any stock in which he became a market-maker.

Market-makers would be free to deal directly with institutions. Limit orders would be fed directly into the quotation system by brokers and there would be no floor brokerage charges.

Merrill Lynch was not entirely clear about how stocks would be assigned to market-makers. There was an implication that any

member of the system could become a market-maker by giving a six-month undertaking as described above. There was also some implication that stocks would be assigned so that each stock had at least one market-maker. An exception to this would involve inactive stocks for which the book would carry any bids and offers available but for which there would be no securities firm acting as market-maker.

2. *The New York Stock Exchange Proposal of July 1976*

The New York Stock Exchange put forward two proposals as useful steps toward a National Market System.[133] The exchange conceded the advantages of a Consolidated Limit Order Book (CLOB) covering the entire national securities market, but it also foresaw substantial disadvantages. It was clear from the presentation that the exchange regarded the protection of its own marketplace and of the role of its specialists as a major objective.

The first proposal – an Electronic Order Indication System – would communicate pending block trades to all markets that had limit order books. These markets could then respond on the basis of the orders on their books and be given limit order protection so that they might participate in the block transaction. The effect of this proposal would be to ensure that all public limit orders were able to participate in block transactions. The exchange claimed that such a system could be implemented quickly and cheaply.

The second proposal was for Broker Representation of Limit Orders in Primary Markets. This system was aimed at bringing to the floor of the New York Stock Exchange any limit orders for New York listed stock placed in other markets.

The exchange's objections to a full CLOB were rather interesting. First, it believed that any specialists and market-makers having access to the CLOB would have to be prohibited from dealing directly with institutional investors and corporate insiders, following the New York Stock Exchange rule for specialists. The exchange also believed that commissions for limit order executions would have to be fixed so that brokers would know in advance what the charge would be regardless of the place of execution. And if the CLOB were extended to permit automatic execution, as Merrill Lynch had proposed, the exchange predicted the end of the auction market.[134]

The exchange did submit recommendations for the structure

133 THE NEW YORK STOCK EXCHANGE, INC., A NATIONAL MARKET SYSTEM: A REPORT BY THE NATIONAL MARKET SYSTEM COMMITTEE (July 1, 1976).

134 *Id.* at 17–18.

of a National Market System. Not surprisingly, these emphasized the preservation of separate exchange markets. Exchanges would trade only the stocks of their choice and would assign stocks to specialists or other market-makers. Specialists would be bound by the kinds of market-making obligations that the New York exchange now imposes. And other market-makers would be bound by similar rules. Competition would be permitted among exchanges, among specialists, and among specialists and market-makers. But the competition would be restricted to prevent market fragmentation. One restriction would come about, of course, by a prohibition against market-makers dealing directly with institutions. Indeed, this restriction alone might eliminate any third market competition with the exchange.

The exchange was quite frank about its concern for maintaining adequate incentives for specialists. The proposal said: "Introduction of a CLOB could lead to the diversion of the floor brokerage income that specialists now receive for executing orders in their limit order books."[135]

3. *Proposal from the American Society of Corporate Secretaries*

This proposal was prepared by Professors Sametz and Bloch of New York University, for the society. The authors aimed at a competitive auction market within a framework of regulated access.[136] But they seem always to have equated auction market with broker market. They were in general agreement with the New York Stock Exchange proposal for close control over the allocation of stocks to market-makers and would give substantial privileges to market-makers accompanied by the responsibility to maintain continuous two-sided quotes in depth. However, they argued for an early CLOB. Indeed, they identified the definition of a CLOB as the key and first decision to be made by the National Market Advisory Board.[137]

But Sametz and Bloch would free the specialist to deal with institutions and would not force specialists to make markets in stocks they did not want. The authors, however, were concerned about inactive stocks and were sympathetic to the idea of not relying on a free marketplace to provide specialist services for

135 *Id.* at 46.

136 National Market Study Committee, American Society of Corporate Secretaries, position paper submitted to the National Market Advisory Board and to the Securities and Exchange Commission 2 (July 29, 1976). The paper was reprinted as E. BLOCK & A. SAMETZ, A MODEST PROPOSAL FOR A NATIONAL SECURITIES MARKET SYSTEM AND ITS GOVERNANCE (1977).

137 *Id.* at 4-5.

those stocks. There was some uncertainty about the amount of regulatory interference that might be called for here.

The Sametz and Bloch proposals would then support an active third market competing with the exchange markets. But it would significantly limit access to the market-making function.

4. *National Market Advisory Board Report to Congress, December 1976*

This *Report* to Congress was on the possible need for modifications of the scheme of self-regulation to adapt it to a National Market System.[138] The board did not recommend any new self-regulatory organization but it did propose "one or more coordinating entities in which the self-regulatory organizations and the public are represented, but in which no one or two existing self-regulatory organizations have a dominant position".[139]

The board expressed some preliminary views on the form it believed a National Market System should take, reserving until later its final prescription. The *Report* reviewed the steps that had already been taken toward a National Market System. The first of these was the consolidated last sale reporting facility, generally referred to as the consolidated tape. There is a consolidated tape association consisting of the New York and American Stock Exchanges, and the Midwest, Pacific Coast and Philadelphia Stock Exchanges and the NASD as voting members, and three non-voting members: the Boston and Cincinnati Stock Exchanges and Institutional Networks Corporation (operators of the "Instinet service"). The association came about as the result of strong pressure from the SEC and produced by March 1976 the consolidated tape, which reported all transactions on all exchanges and in the over-the-counter markets for all issues listed on the New York and American exchanges as well as selected issues listed on other exchanges.

The board commented that the difficulties encountered in bringing about this degree of cooperation among self-regulatory organizations "suggests the inadvisability of including in the charter of a National Market System coordinating or governing entity any veto, or other measure, which would give one or two of the participating self-regulatory organizations the ability to dominate such entity".[140]

138 National Market Advisory Board, Report to Congress: The Possible Need for Modifications of the Scheme of Self-Regulation in the Securities Industry so as to Adapt It to a National Market System (December 31, 1976).

139 *Id.* at 1-2 (Letter of Transmittal).

140 *Id.* at 16-17.

The second step that had been taken was the development of a composite quotation system. The board reported that there were available from two private services composite bid and ask quotations emanating from participating exchanges for securities listed on the New York Stock Exchange which are also traded on other exchanges. The board anticipated that there would soon be a third service which would include third market quotations for New York listed securities. The board commented that the private vendors were initially dissatisfied with the quality of the quotation information provided by the self-regulatory organizations. The SEC had proposed a rule to improve the quality of this information and the board was led to observe:

> "Efforts with respect to the development of a composite quotation system may show whether it is possible for a National Market System facility to be developed through the interplay of competitive forces, with Commission assistance when necessary, but without the creation of a new self-regulatory or coordinating body."[141]

The board strongly advised the commission to allow the industry the primary role in developing a CLOB system. But because of doubts about industry agreement within a reasonable time, the board recommended that the commission proceed with "its analysis and decision-making process". The end result is a rather ambiguous statement about the recommended roles of the industry and the SEC in the development of a CLOB. The board in fact seemed to throw up its hands in the face of strong and diverse feelings within the industry.[142] The board did recommend that the commission prescribe the characteristics of a CLOB and ask the industry to propose plans to meet them.

5. *Proposals for a Consolidated Limit Order Book*

In the course of explaining Rule 19c-1 (which has to do with off-board trading, and is discussed later) and dealing with the obviously attractive objective of protecting public limit orders, the SEC considered proposals for patching up the existing rules on the stock exchanges to extend protection from one floor to another but concluded:

> "It is clear, therefore, that the only fair, realistic and practicable way of mandating satisfaction of public limit orders, a goal the Commission shares with all those witnesses who have stressed the importance of public limit

141 *Id.* at 19.
142 *Id.* at 22-23.

order precedence, is through the creation and development of a composite book and the imposition of a requirement that all transactions, wherever and by whomever effected, must clear that book."[143]

On the existing market structure, the commission said:

"First, as discussed above, limit orders may be avoided, in whole or in part, by a number of techniques, including the execution of a transaction on a regional stock exchange. Second, dual members are not required to satisfy orders on the books of all the exchanges for which they are members before they execute a trade on any particular exchange, and existing technology would make such a requirement, if imposed, wholly impracticable. Finally, existing exchange rules regarding priority and precedence and renewal of the 'auction' after each transaction do not, in our view, provide an ideal framework for the protection of public orders (especially those of small size).

"The Commission believes that the answer to the problem of providing adequate protection for public limit orders is not to maintain existing rules which perforce provide only imperfect protection and have certain undesirable anticompetitive effects, but rather to use the advanced technology now available to provide for a computerized central limit order repository, or composite book. A composite book would permit the effective integration of existing market-makers (both exchange and third market) by ensuring continuation and extension of the public's ability to obtain priority in competing for executions; in addition, such a book would provide brokers and dealers with an efficient and practical means by which all limit orders, regardless of origin, can be protected on a national basis. Once a composite book is in place, the Commission believes that all transactions, regardless of size, should be required to satisfy orders on that book at the same or at a better price either immediately before, simultaneously with or immediately after execution."[144]

One of the most interesting proposals directed specifically to the matter of a quotation system was that of Peake, Williams and Mendelson, submitted to the SEC in April 1976.[145] Their proposal was for a National Book System, with characteristics similar in many respects to those proposed by Merrill Lynch. A single quota-

143 SEC, Securities Exchange Act of 1934 Release No. 11942, December 19, 1975, at 44.

144 *Id.* at 49-50.

145 J. Peake, R. Williams & M. Mendelson, The National Book System: An Electronically Assisted Auction Market (April 30, 1976).

tion system, in effect a single national market, would handle limit orders, execution of the orders, and reporting of transactions. The book would be open for all to see and any broker or dealer meeting SEC qualifications would be permitted to enter orders and to "hit" orders so as to execute transactions. Trading would be carried on in the stocks of companies meeting SEC criteria. The entire system would be run by a self-regulatory organization, the National Securities Board.

Like the system proposed by Merrill Lynch, this system would rely heavily on open competition. No market participant would be given any special privileges with respect to market-making and access to the system. And no securities firm would carry any obligation with respect to market-making. All of these features, of course, were directly opposed to what the New York Stock Exchange wanted. This proposal would give wider access to the book than would the Merrill Lynch proposal and would go somewhat further in erasing the identity of each stock exchange. Peake, Williams and Mendelson would leave to the stock exchanges all functions other than communications, execution and record keeping. But at best this would seem to relegate the exchanges to minor housekeeping and clerical activities. At the same time a new organization was proposed with the possibility that an existing organization, perhaps the New York Stock Exchange itself, might evolve into this new organization.

In January 1977 the National Market Advisory Board itself offered recommendations to the SEC on establishing a Composite Limit Order Book.[146] The board was very cautious with its suggestions and its communication to the SEC suggested that it would have preferred to wait until the industry had moved closer to agreement but felt compelled to offer some advice in view of action the SEC had already taken to increase competition among markets in reliance on an imminent National Quotation System.

The board had concluded that a composite book was called for, apparently dismissing the proposals of the New York Stock Exchange for a simpler substitute. The board also concluded that brokers and dealers should be able to enter limit orders directly into the system without having to go through specialists or other official market-makers. This conclusion, too, conflicted with the proposals of the New York Stock Exchange. Brokers would not be compelled to enter limit orders into the composite book, but would be required to ensure participation of orders in the book in any

146 Letter from National Market Advisory Board to the SEC commissioners, Re: Establishment of a Composite Limit Order Book (January 28, 1977).

transactions. In other words, orders in the book would have protection in any marketplace outside the book.

In what amounted to a concession to the arguments of the New York Stock Exchange, the board recommended that only specialists and qualified market-makers be allowed to actually execute an order in the book, but did not explain who would qualify as a non-specialist market-maker or what obligations would be imposed on specialists and other market-makers.

The board recommended complete visibility of the composite book, with its contents made available to vendors who would be free to sell the information in any format permitted by applicable regulations. Initially, only exchange traded common stocks would be included in the book and this proposal seemed to pave the way for the New York Stock Exchange to become the national market.

In the summer of 1977 in the course of SEC hearings on the abolition of the last of the rules restricting stock exchange members from taking orders off-board (this subject is discussed later), Merrill Lynch presented some specific proposals for a Consolidated Limit Order Book. The Merrill Lynch proposal was a follow-up of its earlier, more general proposal for a National Market System. It dealt with specific steps that could be taken in the near future to develop the National Quotation System so crucial to a National Market System. Merrill Lynch began by commenting that 45% of the daily flow of orders on the New York Stock Exchange were limit orders. On the books of New York Stock Exchange specialists there would be from 200,000 to 250,000 limit orders. The number may seem large but it has declined in recent years. Merrill Lynch argued that it is important to the quality of the stock market to restore the number of limit orders.

Specifically, Merrill Lynch proposed a CLOB consisting of a series of remote terminals linked by a communications network to a central storage and processing unit. Any broker-dealer eligible for membership in the National Market System would be entitled to lease a terminal and enter, cancel, and modify limit orders on behalf of customers or on its own behalf. This system would involve wider access than Merrill Lynch had suggested in its original proposal two years earlier. The contents of the CLOB would be visible to any member of the National Market System but not necessarily to the public.

Merrill Lynch proposed that orders on the CLOB would take priority over orders represented in the "crowd" of traders on the floor of a particular exchange. This of course would tend to make the CLOB market more attractive than the floors of the exchanges. The public would be given no priority over market-makers, however, since Merrill Lynch felt the latter should be encouraged and it

recognized that the CLOB would cut into the existing revenue of specialists. Specialists should also be freed from restrictive rules that prevent them from competing on an equal footing with other market-makers. Market-making would be open to all financially responsible broker-dealers with no affirmative obligations other than a commitment to make a specific two-sided market for a minimum time period.

Merrill Lynch urged strongly that a CLOB should be introduced quickly, before any further major changes were made in the market structure, including the removal of restrictions on off-board trading. Merrill Lynch could see serious dangers in fragmentation of markets but argued that a CLOB would obviate these dangers.

Within a month of the Merrill Lynch proposals, the New York Stock Exchange put forward a fresh set of proposals again in the context of the SEC hearings on off-board trading restrictions. As might be expected, the New York Stock Exchange did not favour a CLOB or anything that looked like a single national market. It urged instead improved linkages among existing exchange markets. Each market would control its own market-makers, with competition among market-makers and among markets. What was more significant about the exchange proposal was the endorsement of a Composite Quote System, available to all market centres so that investors would have access to the best quotes in all markets. Not all limit orders would be entered into the quotation system. Specialists on the New York Stock Exchange, for example, would apparently be able to continue to maintain their own books outside the system. However, and this proposal represented another very significant concession by the exchange, specialists would have to disclose the contents of their books on request to other participants in the system. So all qualified market-makers would have access, one way or another, to all books.

6. *Removal of Restrictions on Off-Board Transactions*

The first affirmative steps by the SEC toward the development of a National Market System involved the elimination of restrictions on off-board transactions. This elimination had the effect of bringing about, at least to some degree, an integration of the exchange and over-the-counter markets. The over-the-counter market referred to here, of course, is the so-called "third market" which is an over-the-counter market in stocks listed on stock exchanges. The market is essentially one for institutions and securities firms and is maintained by firms that do not belong to exchanges.

The SEC action in opening up competition between the exchange and third markets has no obvious direct effect on Canadian securities markets, since there is no third market in Canada. It must, however, have an indirect effect by extending competition in the United States in the trading of interlisted issues, which are Canadian stocks listed on exchanges in the United States as well as in Canada. They are important stocks to the Canadian markets since they account for something like 50% of all trading on Canadian exchanges and the competition of the U.S. marketplace for trading in these stocks is therefore important.[147]

All of the stock exchanges in the United States have rules limiting the ability of members to effect transactions in listed securities in the over-the-counter market either as principal or agent. In all cases, the principle of "displacement" must be respected, which means that before a member may take a transaction off the floor of the exchange, he must permit participation in that transaction by those with limit orders entered in a specialist's book, public bids or offers represented in the "crowd", and bids and offers by members, including specialists, for their own account. For example, if a specialist's book includes an order to purchase 100 shares of a stock at $40 a share, then before a member may take an order to sell at $40 or more off the floor of the exchange he must supply the 100 shares to meet the limit order at $40. The exchanges generally require more, however. Rule 394 of the New York Stock Exchange prescribed a number of steps the member was required to take to explore the market on the floor, obtain permission to go off the floor, and report the details of his transaction.

In December 1975 the SEC announced, after extensive hearings, the adoption of Rule 19c-1 to go into partial effect on March 31, 1976, and full effect on January 2, 1977.[148] The rule provided that after March 31, 1976, the rules of a stock exchange may not prevent a member of an exchange, acting as agent, from effecting transactions in listed securities on other exchanges or over-the-counter with a third market-maker or nonmember block positioner. Until January 2, 1977, it was to be permissible to require members effecting such transactions to satisfy limit orders left with a specialist or represented through any other limit order mechanism. But after January 2, 1977, even these requirements would have to cease. The rule did not affect restrictions on members acting as *principal* off the exchange floor – that subject was not to be tackled until 1977. Nor did it affect restrictions on

147 This competition is discussed in *Williamson, Financial Institutions*, ch. III.
148 SEC, Securities Exchange Act of 1934 Release No. 11942, *supra* note 143.

exchange members effecting transactions "in-house" as agent for both buyer and seller. Only transactions in which the member acted as agent and effected a transaction with a "third market-maker" or "nonmember block positioner" were covered by the rule. The SEC indicated, in announcing the rule, that it favoured the removal of restrictions on in-houses crosses but was deferring action.

The SEC was seriously concerned with the protection of limit orders. It set out quite clearly in its decision an expectation that the ultimate National Market System would provide for the protection of limit orders in all markets.[149] That is, a customer placing an order to buy 100 shares of a particular stock at $40 a share, whether the order was placed with an over-the-counter dealer or a stock exchange member and regardless of the exchange to which the member belonged, would be assured that nowhere within the national securities market would 100 shares be sold for less than $40 unless they were sold to him and that if 100 shares were sold at $40 they would be sold to him unless another order to buy at $40 had been entered before his order. In effect, then, all limit orders placed by all buyers and sellers of securities in the national securities market would be pooled and orders would be filled according to price and time priority. The SEC observed that this ideal had not yet been reached and that while each exchange provided limit order protection for transactions on its own floor, there was nothing to stop a member of two exchanges from taking an order to the floor of one of those exchanges and ignoring the limit orders on the other.[150] While it was sympathetic to a plea that exchanges should be able to limit off-board transactions to protect limit orders on the floor of the exchange, it concluded that this protection need not extend beyond January 2, 1977, with the expectation that complete protection would be coming with a National Market System.

The SEC concluded that the limitations imposed by the exchanges on members acting as principals effectively prevented these members from (i) making a *bona fide* continuous two-sided round-lot market over-the-counter, (ii) executing customers' orders as principal over-the-counter, (iii) "positioning" a portion of a large block (by acquiring stock for their own accounts) over-the-counter to facilitate a block trade, and (iv) acquiring or disposing of investment positions over-the-counter.[151] The agency restrictions effectively prevented a member acting as agent from (i)

149 *Id.* at 43-44, 49-50.
150 *Id.* at 44, 49.
151 *Id.* at 5-6.

effecting an over-the-counter transaction in a security listed or traded on the exchange for a customer directly with a third market-maker or broker or an institutional buyer or seller, (ii) crossing both sides of a large block transaction in-house, acting as agent for both, and (iii) crossing small retail orders in-house, acting as agent for both sides.[152] The principal effect of the limitations on off-board agency transactions, then, was to limit competition between specialists on the exchange and over-the-counter market-makers off it. And it was the restoration of this competition that was the principal aim of Rule 19c-1.

The commission said:

> "Of all the arguments advanced in favour of retaining some form of off-board trading rule requiring that an exchange be interrogated, and that at least certain orders on that exchange be satisfied by a member wishing to effect a third market agency transaction, the most persuasive concerned the desirability of continuing protection for public limit orders, to provide a means for those orders to participate in transactions which otherwise would occur at prices below those which the public is willing to pay or above those at which the public is willing to sell.
>
> "As explained below...the Commission believes that it is essential to create a central mechanism for the national protection of limited price orders. Testimony presented at the October hearings cogently argued that such protection is fundamental to the fairness of our securities markets. Existing exchange mechanisms designed to protect limit orders and provide for their participation in transactions occurring on particular exchanges, however, are inadequate for the future and can be circumvented under existing circumstances by members of 'primary' exchanges (who may transport an order to a regional exchange if avoiding the limit order book on the 'primary' exchange is an important factor in consummating a substantial trade) and by customers (who are not required to effect a transaction on an exchange at all)."[153]

The SEC comments on avoiding the limit order book were reinforced by the news in May 1977 that Pershing & Company planned to divert from the New York Stock Exchange to the Midwest Stock Exchange major portions of its correspondent order flow in forty-one stocks for which it had been a Midwest

152 *Id.* at 6.
153 *Id.* at 43.

specialist. Pershing had the second largest order flow at the New York exchange so that this diversion was of some significance. The chief reason for the diversion was that the Midwest exchange provided better executions on smaller orders.

A number of proposals were made to the SEC offering alternatives to the elimination of restrictions on off-board trading. All of these proposals included preservation of "displacement", or protection of limit orders, and all added further limitations. The commission concluded that all were as objectionable as the existing limitations. The organization and structure of all the exchanges was such that protection of limit orders required that a member physically check the market at a specialist's post and the commission concluded that the time, effort and expense involved in making that check constituted an unacceptable obstacle to the use of third market execution opportunities by member firms acting as agents.[154]

The commission also observed that the existing limitations placed retail customers at a disadvantage relative to institutional customers. First, institutional investors were generally equipped to deal directly with third market-makers whenever they believed it was advantageous to do so, while retail customers were more likely to stay with exchange member firms. Second, member firms were willing to explore all the opportunities for execution of an order of an institutional size and to take the trouble to deal with the many restrictions set up by the exchanges, trouble they would not take with the smaller retail orders. The commission said:

> "It would be anomalous, at best, for the Commission to question the right of an exchange member diligently to explore and use any and all competing markets and methods of achieving executions when individual customers would benefit financially thereby. Exchange restrictions which have the effect of preventing a member from offering professional coverage of competing markets for retail customers, similar to that coverage which members provide to institutional customers, cannot therefore be permitted to continue."[155]

The usual arguments were raised in opposition to Rule 19c-1, arguments that come up whenever efforts are made to increase competition within an exchange or between an exchange and another market. It was said that the rule would induce members of exchanges to abandon their memberships, give rise to a significant loss of orders from exchanges to the third market, result in

154 *Id.* at 31.
155 *Id.* at 45.

the bypassing of public orders entitled to priority, reduce the quality of market-making by specialists, lead to undue concentration in the securities industry, destroy the auction process and lead to dealer markets, annihilate investor confidence in the fairness of the markets, and make the capital raising process generally difficult.[156] There seems to be no evidence that any of these predictions have been fulfilled; at least no evidence has been put forward by those who in 1977 suggested the same consequences in arguing against an SEC proposal to eliminate restrictions on off-board principal transactions.

7. *Proposed Further Removal of Restrictions on Off-Board Trading*

In June 1977 the SEC followed up on Rule 19c-1 with proposals for a modification to that rule and for a new rule, 19c-2. Rule 19c-1 would continue to apply to agency transactions in listed securities but would be broadened to prohibit any limitations on transactions, not just with over-the-counter market-makers and block positioners but also "with another person". (It was, in fact, broadened to eliminate all restrictions except those relating to "in-house" agency crosses as of March 1, 1978.[157])

Rule 19c-2 would apply to "in-house" crosses, as well as to off-board principal transactions. The rule would prohibit any limitation on the ability of a member acting as agent for both buyer and seller to effect an off-board cross transaction. And it would prohibit any limitation on a member acting as principal to effect an off-board transaction with any person. But while Rule 19c-1 applies to transactions in "listed" securities, Rule 19c-2 would apply to transactions in "reported exchange securities". Reported exchange securities is a class within listed securities which includes those listed securities for which last sale prices from all reporting markets are published on the consolidated system. This class would include all the stocks listed on the New York and American Stock Exchanges, and would exclude only some of the stocks listed exclusively on the regional exchanges. Rule 19c-2 would in effect finish off Rule 390 of the New York Stock Exchange, a rule weakened by 19c-1, but still regarded by the exchange as critical to its survival.

The commission had concluded that the exchange off-board trading restrictions effectively prevented exchange members

156 *Id.* at 34.

157 SEC, Securities Exchange Act of 1934 Release No. 14325, December 30, 1977,

other than specialists from competing with specialists and with over-the-counter market-makers in the business of making two-sided, round-lot markets in exchange-listed securities. The restrictions also prevented exchange members from executing their customers' orders in-house from inventory accumulated as a result of market-making or otherwise and precluded members from executing orders periodically for their accounts off-board with third market-makers or with institutions, either for investment purposes or in connection with positioning a portion of a larger block transaction.[158]

In commenting on the experience that had been gained since March 31, 1976, under the limited form of Rule 19c-1, the commission said that the rule seemed to have made little impact on the selection of markets by exchange members acting as agents.[159] The commission observed that none of the exchanges had gone any further than they were required to under Rule 19c-1 in removing off-board principal or agency restrictions.[160] Although the commission was still concerned, as it had been in late 1975, with protection of public limit orders, it pointed out once again that there were deficiencies in the existing protection, both within exchanges and among exchanges and it reported that although the National Market Advisory Board had also expressed great concern over this issue, the securities industry had been unable to reach any agreement on the industry market linkages that would bring about protection of limit orders in all markets.[161]

The commission had resolved that there was no point in deferring its efforts to reduce limitations on off-board transactions in the hope that the industry might come up with improved limit order protection.[162] Rather, the strategy adopted by the SEC seemed to be to force increased competition on the exchange markets, accepting a small reduction in the quality of limit order protection and in the process putting increased pressure on the industry to reach agreement on a composite quotation system.

The SEC also considered the argument that an increase in off-board transactions involves a certain amount of market fragmentation. The exchanges had argued that such an increase would seriously impair the efficiency of the exchange auction market. It

[1977-1978 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 81,397 (announcing the amendment of Rule 19c-1).

158 *Id.* at 17.

159 SEC, Securities Exchange Act of 1934 Release No. 13662, June 23, 1977, CCH Fed. Sec. L. Rep. 22 (extra edition No. 700) (June 23, 1977).

160 *Id.* at 17.

161 *Id.* at 30-32.

162 *Id.* at 23.

was argued that the ability to take in-house crosses off the floor of the exchange might induce the large retail firms to remove a substantial amount of their trading from the exchange floor, which could lead both to a lower quality market on the exchange floor and to inefficiencies and higher costs, as brokers found it more difficult to check on different markets and assure their customers the best price available. In addition, it was argued that the firms engaging in principal transactions with customers might not assure those customers the best price available.[163]

The commission was not persuaded that the danger was great enough to justify delay in removing restrictions. It observed that real-time disclosure of last sale information in the consolidated system should go far to preserve efficiency and fairness. And it noted that once the industry is able to agree on a composite quotation system, the assurance should be virtually complete.[164]

The commission did concede that some regulation might be necessary to prevent overreaching by member firms acting as principals. And it therefore proposed for discussion four versions of a possible Rule 15c5-1. The first version, the "person limit approach", would limit off-board principal transactions to those with other brokers or dealers and with institutions. The second version, the "price limit approach", would require that dealer prices be in line with the best prices appearing in a composite quotation system. The third version, the "disclosure approach", would require that the confirmation of a principal trade disclose the highest bid and lowest offer available in the marketplace. And the fourth version, the "fair dealing approach", would simply impose an obligation on those dealing as principals to offer prices to their customers as favourable as those available in agency trades.[165] (The New York Stock Exchange expressed a preference for a combination of the "price limit" and "fair dealing" approaches.)

As of early 1978 the SEC had not acted to implement proposed Rule 19c-2. Opposition to the rule was organized and widespread. The New York Stock Exchange could be expected to defend what remained of its Rule 390, limiting off-board transactions, but fears were expressed throughout the securities industry, and even within the academic community, and the SEC initiative appeared to be stalled.

163 *Id.* at 48-50.
164 *Id.* at 56.
165 *Id.* at 111-14.

8. *National Clearing and Transfer Facilities*

Among the provisions relating to a National Market System introduced by the Securities Reform Act of 1975 was new section 17A of the Securities Exchange Act of 1934. This section directs the SEC to facilitate the establishment of a national system for clearance and settlement of securities transactions, "having due regard for...maintenance of fair competition among brokers and dealers, clearing agencies, and transfer agents...". In December 1975 the SEC granted temporary registration to a number of existing clearing corporations and depositories and began to work out a set of rules for permanent registration. As it turned out the first rules were developed in the midst of the handling of an application by National Securities Clearing Corporation (NSCC) to take over clearing operations on the New York and American Stock Exchanges by way of a merger of three clearing corporations.[166] When in June 1977 the SEC proposed a set of standards to be used for the registration of all clearing agencies,[167] there had already been bitter complaints that the registration of NSCC was one step toward a monopoly on clearing operations based in New York. Protests came from the Midwest Stock Exchange, the American Bankers Association, the Stock Clearing Corporation of Philadelphia, and the New England Securities Depository Trust Company. In addition, there were complaints in Congress that the SEC was ignoring the statutory intent that competition be fostered. The difficulty seemed to be in trying to combine a substantial degree of competition in the furnishing of stock clearing facilities along with the efficiencies of a national regulated utility.

9. *The Situation in Early 1978*

In its June 1977 proposals for modifications to Rule 19c-1 and its proposed Rule 19c-2 the SEC dealt at some length with the elements of a National Market System.[168] It referred to the consolidated reporting system as fully operational on April 30, 1976; this system disseminates nationally on a current and continuous basis last sale prices from all reporting markets for equity securities listed on the NYSE and for equity and certain debt securities listed on the AMEX. With respect to a composite quotation system, however, the best the commission could say was that limited

166 SEC, Securities Exchange Act of 1934 Release No. 12954, November 3, 1976, [1976 1977 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 80,785.

167 SEC, Securities Exchange Act of 1934 Release No. 13583, June 1, 1977, [1977-1978 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 81,182.

168 SEC, Securities Exchange Act of 1934 Release No. 13662, *supra* note 159.

prototypes of such a system were available and in some use.[169] Although a third element of a national system, a national system for clearance and settlement, had not been achieved, the SEC believed that progress had been made; the National Securities Clearing Corporation had been registered as a clearing agency to take the place of the AMEX, NASD and NYSE clearing corporations. A fourth area, industry market linkage, appeared to have become bogged down. Although the National Market Association had sought industry support for a proposal to construct an electronic intermarket order routing facility, it had been unable to secure agreement among self-regulatory organizations on trading rules to be applicable to the system.[170]

As of early 1978 the elimination of barriers to competition within markets and among markets seemed inevitable. The SEC appeared to be pressing for this elimination, despite warnings that it might be premature, in the belief that it was the only spur likely to move the industry toward agreement on a National Market System. The New York Stock Exchange was trying very hard to preserve as much as possible the character of the exchange markets (and therefore its own supremacy among them) as at least somewhat independent entities within a national marketplace. The specialist's monopoly position seemed due to disappear and the exchange was prepared to sacrifice the secrecy of the specialist's book. Merrill Lynch and others were arguing for a Composite Limit Order Book with more or less unlimited broker-dealer access and in effect a single national marketplace, perhaps permitting the existence of other markets but with the expectation that they would be minor and probably restricted to inactive stocks. The best hope for the New York Stock Exchange, and therefore a likely compromise, seemed to be the evolution of the New York Stock Exchange, perhaps along with the American Stock Exchange, into a new national market. The New York Stock Exchange might at least be able to use its physical facilities to house a new national market and perhaps its clearing facilities as well. However, the NASD, which in NASDAQ already had a highly advanced quotation system, had given indications that it might be willing to develop a National Market System.

In its final report to the SEC in December 1977 the National

169 *Id.* at 24-25.

170 *Id.* at 31. Another difficulty has to do with exclusivity. A New York Stock Exchange subsidiary, Securities Industry Automation Corp., has a Common Message Switch (CMS) system which automatically routes orders to the New York or American exchanges. But the Midwest Stock Exchange complained in 1977 that the system should be able to direct orders to it and the broader question is whether any order

Market Advisory Board was quite divided in its views on what action the commission should take. Two members favoured the Merrill Lynch type of CLOB; four favoured a CLOB coexistent with other markets offering executions only to specialists and other "qualified" market-makers; three favoured market linkages, and two favoured commission action involving no more than the development of a composite quotation system. All believed that at least a composite quotation system should be in place when off-board trading restrictions were removed.

B. DEVELOPMENTS IN CANADA: CATS AND CANADA-WIDE

Planning toward a national securities market in Canada, the "Canada-wide securities market system", has been undertaken by a committee representing the Toronto, Montreal and Vancouver stock exchanges, and the Investment Dealers Association of Canada. The committee developed a conceptual model of the system in late 1975 which was put before the sponsors.[171] However, the ultimate form of the model and its method of implementation will depend very much on the development of a computer based trading system. The development is taking place in the form of the Computer-Assisted Trading System (CATS) research project at the Toronto Stock Exchange, which is described in some detail in Cleland, *Applications of Automation*, in this volume,[172] but a brief discussion may be helpful.

1. *CATS*

Work on CATS was begun in 1969 when the Toronto Stock Exchange concluded that some improvements in trading facilities were necessary to handle the rising volume of the exchange. It was decided to explore the possibility of a computer system that would enable trading to take place via terminals in members' offices rather than by traders meeting face-to-face in a trading room. If it was not possible to replace all face-to-face trading, then there was still the possibility of replacing some of it or at least making it more efficient through electronic communication.

In 1975 the first stage in the system development was

routing system should automatically seek out the best execution regardless of market.

171 COMMITTEE FOR THE DEVELOPMENT OF A CANADA-WIDE SECURITIES MARKET, A CONCEPTUAL MODEL OF A CANADA-WIDE SECURITIES MARKET (June 23, 1975) (revised October 2, 1975).

172 *See*, Cleland, *Applications of Automation*; a technical description is given in *Jenkins, Computer Communications Systems.*

reached, in the form of CANDAT II, a market information system, providing quotations through terminals. CANDAT II was made available to TSE members and others and proved a successful product. What remained to be done was the inclusion of the entire "book" of limit orders and the addition of execution ability. By November 1977 the technical implementation was complete and tests were begun on CATS.

Initially, trading in six relatively inactive stocks was transferred to CATS. CATS operates through CANDAT II terminals which display on request to those with CATS access the "book" in these six stocks, showing prices and size of the bid and offer sides and codes identifying the source of each bid and offer. Members with access can complete an execution through their terminals.

In March 1978 the list was expanded to a total of eighty relatively inactive stocks, with thirty member firms entering orders from office terminals.

As of early 1978, it was not clear whether CATS could satisfactorily replace face-to-face trading on the floor of the exchange. United States experience was so far not helpful since the Consolidated Limit Order Book (CLOB) system had not yet been implemented anywhere to completely replace floor trading. Indeed, this was an aspect of trading about which U.S. markets might be able to learn from Canadian experience. However, putting the relatively inactive stocks on CATS is far from conclusive testing. The inactive stocks are traded at Posts 10 and 11 on the floor of the Toronto exchange. Members file their bids and offers in pigeonholes at these posts so that there is essentially a book of bids and offers in all of these stocks open for all members to see. Putting this book into a computer and substituting entries at a terminal for the physical filing of bids and offers at Posts 10 and 11 and the physical finding of members who entered these orders to complete a transaction does not suggest great difficulty. But for the active stocks the book of bids and offers consists of order slips carried by the floor attorneys for member firms. There is a strong inclination to keep these orders confidential and many believe that good executions can only take place among these attorneys meeting face-to-face in negotiation. Certainly those member firms that believe they possess a competitive edge in these negotiations have reason to resist the implementation of CATS.

The New York Stock Exchange has had good reason to be cautious about the development of a national system in the United States, but the CATS system in Canada is the product of a single exchange and the dominant exchange at that. It offers no immediate threat of sharing the market for Toronto listed stocks with outsiders and even if the system were to be extended to embrace

other stock exchanges in Canada, there is a sufficient overlap of memberships that the Toronto members have little to worry about. In the United States it is clear that the CLOB as proposed would integrate trading on the New York Stock Exchange with trading on the regional exchanges and in the third market. So specialists on the New York exchange can see in a CLOB a very serious threat to their business. Member firms in general see the likelihood of a move to dealer, rather than broker, markets. This move is distressing to some, but not all.

2. *The Canada-Wide Securities Market*

Just as the final development of a model for a Canada-wide system is waiting for confirmation of the feasibility of the CATS system, so the impetus for planning the system came from CATS. When the Toronto Stock Exchange undertook to develop CATS, the Montreal exchange was faced with a dilemma. There is a substantial overlap of membership and listed stocks between the Toronto and Montreal exchanges. Over 90% of the business on both exchanges is done by firms that belong to both. Probably two-thirds of the business on the Toronto exchange and 80% to 90% of the business on the Montreal exchange is in stocks listed on both. If the Toronto exchange were to implement a highly successful CATS, one demonstrating the superiority of computer based trading over face-to-face trading on an exchange floor, then the floors of both exchanges might disappear to be replaced by Toronto's trading system. This would probably be of little concern to the Montreal members who also trade on the Toronto exchange but would be a serious blow to the few firms that are members only of the Montreal exchange, and it might be painful, too, for the government of Québec.

The Montreal exchange, with resources considerably smaller than those of the Toronto exchange, could hardly attempt to develop an even better computer based trading system to capture the trading of the two exchanges. What it did was to propose the development of a Canada-wide system. The Toronto and Vancouver exchanges and the IDA took up the proposal and a project committee was formed. (The Alberta Stock Exchange was added to the committee in 1977.) Work began in 1973 on a conceptual model which was put before the sponsors in late 1975.

What the committee put forward was essentially a plan for a new securities market: the Canada-wide securities market. If the CATS trading system were successfully developed by the Toronto Stock Exchange, then the Canada-wide market would be built around that system. This was directly analogous to a United States

National Market System built around a CLOB. If CATS cannot be successfully developed, it is not clear just what form the Canada-wide market might take. But the committee's report suggested an attempt would be made to develop a floor trading system, one that sounds like a scheme for electronically linking the trading floors of three exchanges, perhaps in a manner similar to the linkages that have been evolving for stock exchanges in the United States.

The committee proposed a new entity to operate the Canada-wide system, which would be owned and controlled by the sponsors, and which would perform many of the functions of a self-regulatory organization including the disciplining of members. The committee did not discuss the question of responsibility of this new entity to a regulatory commission. But since the entity was proposed as an Ontario corporation, presumably it was contemplated that the Ontario Securities Commission, at least in the absence of any federal regulatory commission, might have jurisdiction over it.

The committee proposed that initially the Canada-wide system would include all stocks listed on the TSE plus stocks listed on the MSE and VSE meeting the current TSE listing requirements. All members of the three stock exchanges as of May 31, 1975, would have access to the Canada-wide system and new members of any of the three exchanges might be put forward by their exchanges as candidates for the Canada-wide system and might be accepted into it. This scheme could present some difficulties, if the Canada-wide system includes all of the TSE listed stocks and it becomes possible to gain trading access to all of these stocks without actually joining the TSE. The committee anticipated the possible depressing effects of the Canada-wide system on the value of a stock exchange membership and proposed that these effects be provided for in establishing membership fees for Canada-wide.

The conceptual model contemplated a highly centralized system and the industry was far from unanimously in favour of it. As of early 1978 it seems likely that the future of a Canada-wide system depends almost entirely on the future of CATS. Indeed the design of Canada-wide will become a matter of describing access to CATS.

Given a successful CATS, the Toronto Stock Exchange will presumably become the Canada-wide system for stocks listed on the TSE. So the TSE membership should be in a very strong position. Since these member firms, or some of them, dominate the trading on the Montreal and Vancouver exchanges, they have little reason to object to a cooperative Canada-wide system, at least so long as they are compensated for giving up some trading in

Toronto listed stocks to firms that are members only of the Montreal or Vancouver exchanges.

It is possible, of course, that a government or a regulatory agency confronted with a computerized marketplace, national in scope, might insist on the irrelevance of the TSE origin and create a new self-regulatory organization to operate the market. The likelihood of this happening, however, may depend on the TSE's willingness to accommodate the other exchanges in a Canada-wide entity.

C. TRANSFER BY BOOK ENTRY

A national securities market suggests, although it does not demand, a national clearing system. The Canadian securities industry can certainly cope with regional clearing – with a separate clearing organization for each stock exchange, for example. But a unified national system offers the prospect of economy and perhaps increased convenience. A national clearing system, in turn, suggests further economy in some method of securities transfer that does not involve the physical handling of certificates. The ideal seems to be a transfer system that consists entirely of book entries. The securities themselves are held by a central depository and the beneficial owners have their interests recorded on the books of the depository. A transfer of beneficial ownership requires no more than a debit and a credit entry on those books. Substantial progress has been made in both Canada and the United States toward this method of transfer. The details are discussed elsewhere[173] but a brief description is given here because transfer facilities are an important part of the securities market.

In the United States the Depository Trust Company was established in 1973 and is run by representatives of banks and a life insurance company, as well as representatives of broker-dealers and stock exchanges. Participation by banks is important, since this means that the banks are willing to accept stock held by the depository as collateral. A large number of institutions in the United States are now making use of Depository Trust Company, because transfers effected through its books can be both faster and cheaper than transfers that involve the movement of certificates.[174]

Just as the development of a national clearing system has confronted the SEC with a difficult choice between competition

173 *See, Cleland, Applications of Automation.*

174 The Municipal Securities Rulemaking Board has endorsed a proposal by Depository

and monopoly, so the same choice has emerged with respect to depositories. Indeed, since clearing, transfer and depository functions are all closely intertwined, all three call for some simultaneous resolution of the conflict.

In Canada work on the Canadian Depository for Securities Limited (CDS) began in 1968. In 1969 a staff was hired and a substantial financial commitment was made by organizations representing banks, life insurance companies, mutual funds, trust companies, and the securities industry. CDS developed a standard securities identification system and a securities settlement system (for institution and dealer settlement) that is now in operation. The clearing operations of both the Montreal and Toronto stock exchanges have been turned over to CDS.

As of early 1978 CDS had not yet become a depository. It serves as a convenient clearing agent to bring about exchanges of cash and securities among the dealers and institutions that are its members and it is able to reduce the flow of cash and securities by netting the obligations of all parties and calling for transfers to meet only the net obligations. It also has a linkage with the Depository Trust Company in the United States. But CDS has no inventory of securities (although it uses its own bank account in the process of transferring cash among its members). Depository status is waiting for a book entry transfer system.

There are many obstacles to full implementation of a book entry transfer system. Banks and trust companies in particular are concerned about the legal aspects of a transfer effected without a certificate. Closely related are concerns about detection of errors, prevention of fraudulent or improper transfers, protection of collateral, and all the safekeeping aspects of securities ownership. In addition, the book entry system represents a change from the traditional custodian and transfer functions of trust companies, and a number of trust companies are naturally suspicious that a change will do them an injury.

D. CONCLUSIONS AND POLICY IMPLICATIONS

Securities markets in the United States and Canada are competitors, and the competition became especially noticeable in 1976 and 1977. There was, as of early 1978, a growing conviction in the United States that the securities business will become still more competitive and that dealer markets will largely replace broker markets in stocks. As a result, the industry has been busy reorga-

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Trust to handle municipal bonds through a book entry system; Securities Week (New York), August 15, 1977, at 6.

nizing itself through mergers, building strength across underwriting, trading and distribution and building the capital needed to carry dealer inventories. It may be helpful to Canadian markets to lead United States markets in the improvement of efficiency. But it may be crucial to at least avoid lagging the U.S. markets. If the United States attractions of lower commission rates and more liquid markets are supplemented by a vastly improved trading system, it may be very difficult for the Canadian exchanges to hold their share of trading in interlisted issues.

So far as automated trading is concerned, and substitution of terminals for face-to-face negotiation, Canadian systems testing may be ahead of American testing. CATS, on a limited basis, was doing in early 1978 what no system in the United States was yet doing. The delay in the United States is not one in technology. The computer-based trading systems are available. But the industry has not yet been able to organize itself to use the technology. It may well be that under congressional and SEC pressure there will be a great leap forward and the Canadian industry may have a chance to observe automated trading in some very active stocks. The risk to Canada lies in the possibility that the United States industry will be prodded or forced into a system that proves highly successful and attracts trading before the Canadian industry is able to agree on the full implementation of CATS.

The anticipated move in the United States toward greater dealer activity presents another competitive challenge. The Canadian industry is almost unanimous in viewing dealer activity with great suspicion. If, as seems likely, increased dealer market-making becomes part of the U.S. National Market System and provides greater depth and liquidity, that market will become even more attractive to Canadian as well as United States investors.

Competition or potential competition from U.S. markets, together with a wish to improve the efficiency of trading, are the principal motivation for developing CATS and a Canada-wide system. Unlike the United States industry, the Canadian industry is not being pressured by governments, regulatory agencies, or components of the industry itself. At the same time Canada is free of most if not all of the fears and resistance within the industry that have plagued development of a national system in the United States.

Appendix:
Computation of Rates of Return

1. *Bankers' Acceptances*

The Bank of Canada tabulates annualized yields on 30-day bankers' acceptances. These rates, when divided by 12, give the monthly rates of return. The wealth relative was set at 100 as of the beginning of 1964, and compounded forward. For example:

$$\begin{Bmatrix}\text{wealth relative}\\ \text{end of}\\ \text{January 1964}\end{Bmatrix} = \begin{Bmatrix}\text{wealth relative}\\ \text{beginning of}\\ \text{January 1964}\end{Bmatrix} \times (1 + \text{January rate of return})$$
$$= 100 \times (1 + .0369/12)$$
$$= 100.31$$

$$\begin{Bmatrix}\text{wealth relative}\\ \text{end of}\\ \text{February 1964}\end{Bmatrix} = \begin{Bmatrix}\text{wealth relative}\\ \text{beginning of}\\ \text{February 1964}\end{Bmatrix} \times (1 + \text{February rate of return})$$
$$= 100.31 \times (1 + .0369/12)$$
$$= 100.62$$

The end of December wealth relatives are given in table 16.

Adjustment for inflation was handled as follows:

$$\begin{Bmatrix}\text{wealth relative}\\ \text{after inflation}\\ \text{adjustment for}\\ \text{end of month}\end{Bmatrix} = \begin{Bmatrix}\text{wealth relative}\\ \text{before}\\ \text{adjustment}\end{Bmatrix} \times \begin{Bmatrix}\dfrac{\text{consumer price index}}{\text{end of 1963}}\\ \text{consumer price index}\\ \text{at end of month}\end{Bmatrix}$$

$$\text{for December 1964} = 103.75 \times 77.90/79.40$$
$$= 101.79$$

The inflation-adjusted wealth relatives are shown in table 17.

2. *Treasury Bills*

The Bank of Canada tabulates yields on 3-month Government of Canada Treasury Bills. One-month rates of return were calculated on the assumption that a 3-month bill is purchased at the beginning of a month at a price given by:

$$\text{price beginning of month} = \frac{100}{\left(1 + \dfrac{\text{quoted annual yield at beginning of month}}{2}\right)^{1/2}}$$

which is the present value of $100, discounted for one quarter at the quoted yield. It was assumed that the bill was sold at the end of a month at a yield that was the average of the 3-month yield quoted at that time and the yield one month before:

$$\text{price end of month} = \frac{100}{\left(1 + \frac{\text{yield at end of month} + \text{yield at beginning of month}}{4}\right)^{1/3}}$$

The average yield was used as an approximation of the yield on a two-month maturity and the expression above discounts $100 for two months at that rate.

The month's rate of return was calculated as:

$$\text{monthly rate of return} = \left(\frac{\text{price end of month}}{\text{price beginning of month}}\right) - 1$$

The wealth relatives were then calculated as in the case of bankers' acceptances with an initial value of 100 at the end of 1933 and adjusted for inflation in the same way.

3. *Government of Canada Long Bonds*

The Bank of Canada publishes yields to maturity for these bonds. It was assumed that a bond was purchased at par at the beginning of a month (the coupon was therefore assumed equal to the quoted yield to maturity at the time of purchase) and was sold at month end. It was also assumed that at purchase the bond's maturity was 18 years and therefore that at the sale date it was 17 years, 11 months. If the quoted yield is $2 \times C$ at the beginning of the month and $2 \times Y$ at the end of the month, the price at month end, plus accrued interest, is given by:

$$\text{Price plus accrued interest at month end} = C \times \left(\frac{1 - (1 + Y)^{-35}}{Y} + \frac{100}{(1 + Y)^{35}} + C\right) \Big/ (1 + Y)^{5/6}$$

The monthly rate of return was calculated as:

$$\text{monthly rate of return} = \left(\frac{\text{end of month price} + \text{accrued interest}}{100}\right) - 1$$

Wealth relatives were calculated just as for banker's acceptances, beginning with 100 at the end of 1934.

4. *Provincial, Municipal and Industrial Bonds*

The Bank of Canada publishes yields to maturity for these 3 classes of bond, obtained from McLeod Young Weir. Rates of return and wealth relatives were calculated as described above for government bonds. Wealth relatives were all initialized at 100 as of the end of 1947.

5. *Toronto Stock Exchange Index*

For the years since 1956, the Toronto Stock Exchange has tabulated its "300" Index which is published with the accompanying dividend. The monthly rate of return is given by:

$$\text{monthly rate of return} = \left(\frac{\text{month end index value} + \frac{\text{dividend}}{12}}{\text{beginning of month index}} \right) - 1$$

For earlier years, since 1933, an earlier index series was spliced to the new series. An adjustment factor of 0.181802 was used, reflecting the relationship between the two indexes over a year. The dividend yield was assumed to be 3% annually from the start of the series at the end of 1932 to the end of 1954. Yields computed by the exchange were used for succeeding months. Monthly rates of return were used to compute wealth relatives as for bankers' acceptances, with a value of 100 as of the end of 1932.

Constitutional Aspects of Federal Securities Legislation

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September 1978

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"...the assertiveness of the federal legislature may exert pressure upon the court as to the view to be taken of the reach of constitutional power...the inflexibility of the Privy Council, for eighty years Canada's final court, appears to have diluted federal legislative courage."*

Chapter I
Introduction

The importance of the securities market has been emphasized in recent years by repeated statements of the vast amounts of investment capital required by Canadian industry during the next decade, especially for the development and exploitation of new sources of energy, for transportation and for the financing of small businesses.[1] Such statements at once highlight the primary function of the securities market and the need for it to perform that function effectively. Although securities markets are often defined in terms of the secondary markets, in Canada essentially the stock exchanges, economists generally agree that the allocation of funds from savers to users is the most important function

* B. Laskin, The Institutional Character of the Judge 18 (The Hebrew University of Jerusalem Lionel Cohen Lectures 1972), *reprinted in* 7 Israel L. Rev. 329, 342 (1972).

1 *See e.g.* Report of the Royal Commission on Corporate Concentration 259 (1978) ("between $460 and $520 billion"); A. Kniewasser, Address to the Association of Canadian Advertisers Incorporated, Toronto, May 1, 1978.

of the securities market; in other words, the primary function of a securities market is to facilitate the acquisition of capital from investors by industry.[2] The efficiency with which the market performs this allocational function affects the productivity of industry, employment and income and thus the overall growth of the economy.

However, if the primary market is to operate efficiently, it is necessary that the secondary market do so as well; the latter market not only enables investors to dispose of their investments, thus providing them with the security of liquidity, but also provides the basis for the pricing of new issues, that is, for the cost of capital. In short an efficient trading market enhances the allocational efficiency of the primary market by establishing an accurate pricing mechanism for new issues and by increasing investor confidence and concomitantly the readiness of investors to purchase such securities.[3] It is not surprising, therefore – indeed it is necessary – that the volume of trading in the secondary market far exceeds that in the primary.[4]

Investor confidence and an efficient securities market are complementary conditions, each contributing to the other. Securities legislation, therefore, has generally been intended to increase investor confidence by ensuring the fair operation of the market with the ultimate purpose of enhancing its efficiency.[5] And it has done so by a number of intermediate techniques such as the licensing of securities professionals in order to ensure their honesty, competence and financial stability, disclosure requirements so that investors may have equal access to information relevant to their investment decisions, and the prohibition of manipulative and other fraudulent methods of trading. More recently it has been used to regulate directly the self-regulatory bodies in order to encourage them to supervise their members, to deter anticompetitive conduct and even to regulate the cost of transactions established by them.

An efficient securities market may also aid in the achievement of other policy goals. Most obviously, it encourages savers to

2 *See generally, Williamson, Capital Markets*, ch. II; W. Baumol, The Stock Market and Economic Efficiency (1964); Friend, *The SEC and the Economic Performance of Securities Markets*, in Economic Policy and the Regulation of Corporate Securities 185 (H. Manne, ed. 1969); *see also* Mendelson, *Economics and the Assessment of Disclosure Requirements*, 1 J. Comp. Corp. L. & Sec. Reg. 49 (1978).

3 *See e.g. Williamson, Capital Markets*, ch. II.

4 *See id.* ch. I; *see also* Ontario Securities Commission Disclosure Report at 27 n. 51 (new issues filed with OSC in 1968 less than 10% of value of trading on Toronto Stock Exchange in same year); *cf.* Wheat, *The Disclosure Policy Study of the SEC*, 24 Bus. Law, 33, 34 (1968) (proportion of secondary to primary markets in the United States is 50 or 60 to one).

5 *See e.g.* Kimber Report, pt. 1, and in particular ¶ 1.12.

employ their funds productively and enables both individuals and institutions to participate in the ownership and control of business enterprise. Moreover, by encouraging investment, in particular equity investment, it facilitates Canadian ownership of such enterprises and also enhances foreign portfolio investment as an alternative to foreign direct investment, thus providing at least a partial solution to foreign ownership of Canadian industry.[6]

That the functions performed by the securities market transcend provincial boundaries is undeniable and economists have long recognized that the financial market in Canada is national in scope.[7] Indeed this fact is demonstrated by the cooperative efforts of the provincial securities administrators, for example, in the adoption of "national policy statements" and in particular by the first such statement which establishes a cooperative system to avoid unnecessary delays in the clearance of prospectuses for national issues.[8] It is clear that provincial borders are irrelevant to buyers and sellers of securities unless artificial boundaries are erected by law and that the efficient functioning of the primary market in Canada, if nothing else, creates pressures compelling the adoption of national policies.

The national character of the securities market is emphasized by the operations of the Canadian securities exchanges and by the process through which they obtain approval of their commission rates. The exchanges invariably settle on a commission structure among themselves and then each exchange applies to the securities commission in its province for approval. If a commission denies approval, the exchanges renegotiate with each other in order to develop a new structure that satisfies it. The initial application is usually made before the Ontario Securities Commission by the Toronto Stock Exchange and once it receives that commission's approval other commissions may be forced to accept a compromise with which they may disagree.[9] Similarly a single clearing facility

6 *See e.g. Howard*, text accompanying n. 37 and following.

7 *See e.g.* Porter Report; *cf.* Report of the Committee to Study the Requirements and Sources of Capital and the Implications of Non-Resident Capital for the Canadian Securities Industry ¶ 4.4 (1970) [hereinafter Moore Report]; and *see* Canadian Mutual Fund Report, especially ch. 19.

8 *See* National Policy Statements Nos. 1-29, 2 CCH Can. Sec. L. Rep. ¶¶ 54-838 - 54-867; National Policy No. 1 is entitled "Clearance of National Issues". *See also* Uniform Act Policy Statements Nos. 2-01 - 2-12, 2 CCH Can. Sec. L. Rep. ¶¶ 54-871 - 54-882, adopted by the "uniform act" provinces, Alberta, British Columbia, Manitoba, Ontario and Saskatchewan. *Cf.* Report of the Study Committee on Financial Institutions 131-35 (Québec 1969).

9 *See e.g.* QSC Task Force, Commission Rates in the Securities Industry (June 1976); Updated Report on Commission Rates in the Securities Industry (December 1976) (opposing fixed rates). The report is summarized in *Williamson, Financial Institutions*, ch. III.C.

for options traded on the Montreal and Toronto exchanges was developed primarily as a result of the Ontario Securities Commission which required the two exchanges to cooperate in its establishment.[10] And even the Ontario Commission has found itself in the unenviable position of either accepting a uniform set of rules for takeover bids made through the facilities of a stock exchange which had been approved by several other commissions for the exchanges in their provinces, but with which the Ontario Commission disagreed, or depriving Ontario investors of an opportunity to profit in a bid made subject to those rules in other provinces.[11]

Even more important, technological developments are underscoring the national character of the market with the increasing use of automation in the dissemination of trading information, the clearing and settlement of securities and even the trading of securities.[12] Information on transactions on each of the major stock exchanges in Canada is available on all three trading floors. The Canadian Depository for Securities handles the clearing and settlement of trades for the Toronto and Montreal Stock Exchanges and also has connections with the Depository Trust Company, its counterpart in New York; and the Vancouver Stock Exchange Service Corporation performs a similar function for that exchange and for the Alberta Stock Exchange. Most significant, the Computer-Assisted Trading System which is now being tested at the Toronto Stock Exchange enables stock to be traded by means of computer terminals in the offices of its member firms instead of on the exchange floor and appears likely to lead to an automated Canada-wide trading system which would replace the trading floors of all the Canadian exchanges.

Automation of the Canadian market will complement the already increasing internationalization of securities markets. Although Canadian developments have been alleged to be somewhat ahead of those in the United States, the U.S. securities market is headed in a similar direction. Forty-four years ago the United States Congress, recognizing that the stock exchanges in the United States were institutions with national economic impact, passed the Securities Exchange Act of 1934 to regulate their activities. In the early part of this decade Congress again considered the securities market and enacted the Securities Reform Act

10 *See In re* The Montreal Options Clearing Corporation, [1976] OSC Bull. 93, 99-101 (March).

11 *See In re* Bralorne Resources Limited, [1976] OSC Bull. 258 (September) ("stock exchange takeover bid" made by Cornat Industries Limited for shares of Bralorne Resources Limited through Vancouver and Montreal exchanges). *See also infra* text accompanying notes 15-16, 64-69.

12 *See generally, Cleland; Jenkins; Williamson, Capital Markets*, ch. IV.B, C; *see also infra* ch. III.C.

of 1975 which, *inter alia*, requires the Securities and Exchange Commission to direct and supervise the development of a "national market system for securities".[13] The proposals for that system have been premised on the use of computerized trading[14] and it is likely that when the system is developed some links with a parallel computerized trading system in Canada will also be established. Similar developments are occurring in the United Kingdom and computer connections with the securities market in Britain, and even Japan, now seem possible of achievement.

Even without such a system, however, it is clear that the securities markets are not only transprovincial but also transnational as was shown recently in the acquisition by Alberta Gas Trunk Line Company of over a third of the outstanding shares of Husky Oil Limited in order to defeat announced takeover bids by Petro-Canada Limited and Occidental Petroleum Corporation. As the shares of Husky Oil were listed on the American as well as the Toronto Stock Exchange, Alberta Gas was able to purchase the shares in the United States in a manner which is precluded by the by-laws of the Canadian exchange[15] and thus use to its own advantage the differences between the rules governing acquisitions in the two jurisdictions.[16]

Investors have thus always ignored national borders in relation to their investment decisions. Perpetrators of frauds have done likewise and have exploited the potential for evasion of securities laws by organizing fraudulent schemes on an international basis.[17] The obvious example is Investors Overseas Services Ltd., the activities of which caused some damage to Canada's international reputation.[18] There have been other examples as well; in recent years both the Quebec and British Columbia Securities Commissions have attempted to prevent local issuers from selling their securities abroad.[19]

All of the above factors indicate the inevitability of some form of federal involvement in the regulation of the Canadian securities market. Recent recommendations for amendment of the income tax laws to encourage investment in equity securities ensure this

13 Securities Exchange Act of 1934, s. 11A, added by Securities Reform Act of 1975, s. 7.

14 *See generally, Williamson, Capital Markets*, ch. IV.A.

15 *See* TSE By-Laws, pt. XXIII (maximum of 5% of shares may be purchased in 30-day period).

16 *See e.g.* Carruthers, *AGTL Raises Holding in Husky to 35%*, The Globe and Mail (Toronto), June 28, 1978, at B1, col. 4.

17 On international enforcement problems generally, *see, Hebenton & Gibson.*

18 *See* 1 Mutual Fund Proposals at 52.

19 *See e.g. In re* Rock Enterprises Limited, 8 QSC Bull., No. 39 (Decision 5357, Septem-

result[20] and reinforce the national economic implications of the functioning of the securities market. It is the responsibility of the federal government to consider the interest of the country as a whole.

Indeed, it is perhaps to be expected that the provincial commissions will tend to emphasize local policies and interests.[21] On occasion parochial interest has even become dominant to the detriment of the efficient functioning of the market. The prime example is the implementation of a policy in 1969 by the Quebec Securities Commission requiring orders received in Québec to be filled on the Montreal or Canadian Stock Exchange;[22] the application of the policy as a basis for disciplining a registrant for executing a Québec order on the Toronto Stock Exchange[23] resulted in a retaliatory amendment to the Toronto Exchange's by-laws precluding arbitrage transactions by its members with the Québec exchanges[24] and thus served to some extent to balkanize the Canadian market. Once enacted, the policy and the accompanying restrictions persisted; in fact, the policy was not repealed until within the last year[25] and the exchanges announced only within the last few months that agreement has been reached on repeal of the "anti-freighting" rules.[26]

The recent removal of the barriers to arbitrage emphasizes the movement toward a Canada-wide trading system.[27] In short

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ber 22, 1977); *see also In re* Développement Morin Heights (Canada) Limitée, 9 QSC Bull., No. 26 (Decision 5593, June 14, 1978).

20 *See e.g.* REPORT OF THE ROYAL COMMISSION ON CORPORATE CONCENTRATION, ch. 11 (1978).

21 *See e.g. In re* The Montreal Options Clearing Corporation, [1976] OSC Bull. 93, 96-97 (March) (Commission hesitant to authorize options trading by Chicago Clearing Corporation as might "hinder the development of a similar options market in Ontario - a development the Commission wished to encourage").

22 *See* Policy Statement No. 4, 3 CCH CAN. SEC. L. REP. ¶ 66-015; *cf.* Notice re: Buy and Sell Orders of Securities Originating in British Columbia, B.C. Corporate and Financial Services Division Weekly Summary, September 12, 1975, at 8.

23 *See In re* Mills, Spence & Co. Limited, 1 QSC Weekly Summary, No. 4 at 2 and 4 (1970) (Decision Nos. 1107 and 1049 respectively).

24 *See, TSE Moves to Curb Block-Trade Outflow*, The Globe and Mail (Toronto), September 2, 1970, Bl, col. 4 at col. 5; Editorial, *One Act of Discrimination Provokes Another*, The Globe and Mail (Toronto), September 4, 1970, at 6, col. 1; Balfour, *MSE, CSE to Discuss Toronto Restriction*, The Globe and Mail (Toronto), September 5, 1970, at B2, col. 4; Sugar, *Arbitrage Now Could Become an Ugly Battle*, The Financial Post, September 19, 1970, at 22, col. 6.

25 *See* Notice: Abrogation of Policy Statement number 4, 8 QSC Bull., No. 35, September 6, 1977 (Decision No. 5316, August 31, 1977). The decision is especially interesting in that it recognizes the likely development of a nationally integrated trading market.

26 *See, Exchanges Agree on Rules*, The Globe and Mail (Toronto), June 14, 1978, at B8, col. 6.

27 *See supra* note 25.

there is already a substantial computer network that links the Canadian exchanges for limited purposes and it appears likely that in the not-too-distant future there will be one automated Canadian exchange through which both trading and settlement occur. This development makes federal involvement in the regulation of the market essential, both as a matter of policy and because the provinces lack jurisdiction to regulate an interprovincial undertaking.[28] In any event, even the present limitations on their authority may on occasion impede the ability of the provincial legislatures to deal effectively with fraudulent or other transactions that are interprovincial or international as was shown in the Husky Oil case mentioned above.[29]

It is clear that the federal government has an interest in the efficient functioning of the securities market in Canada. In fact, it is already involved in its regulation through the tax laws and the prohibitions against fraud contained in the Criminal Code[30] and this involvement is likely to increase with the developing role of financial institutions – for example, banks – in the market.[31] Moreover, the federal government has long engaged in international negotiations relating to the securities market in connection with treaties and to obtain beneficial treatment for Canadian corporations,[32] and in light of the developments in the Canadian and international markets outlined above, its involvement in this area too is likely to increase. It is, therefore, the purpose of this paper to outline the constitutional basis in Canada for securities legislation and, in particular, the jurisdiction available to the federal government to enact such legislation.

Chapter II
Provincial Jurisdiction over Securities

Although there is some federal legislation affecting the secur-

28 Interprovincial undertakings are discussed *infra* ch. III.C.

29 *See supra* text accompanying notes 15 and 16; *see also* Black v. Doherty McCuaig Ltd., [1974] 4 W.W.R. 342 (B.C.S.C.). The scope of provincial jurisdiction to regulate the securities market is discussed in ch. II.

30 *See e.g.* Criminal Code, ss. 338-42, 358.

31 *See* An Act to Revise the Bank Act, Bill C-57, 30th Parl., 3d Sess. (First reading May 18, 1978); *see generally, Williamson, Financial Institutions*, ch. IV. And *cf.* An Act Respecting Bankruptcy and Insolvency, Bill S-11, 30th Parl., 3d Sess., pt. VII (First reading March 21, 1978).

32 *See e.g.* Foreign Direct Investment in Canada 279-80 (Canada 1972), outlining the negotiations between the Government of Canada and the Securities and Exchange Commission in the mid 1960s in order to retain exemptions for Canadian corporations from the reporting requirements of the Securities Exchange Act of 1934. For a discussion of the treaty-making power, *see generally* P. Hogg, Constitutional Law of Canada, ch. 10 (1977) [hereinafter cited as P. Hogg].

ities market,[33] only the provinces have enacted statutes that can properly be termed securities acts. Indeed, since their entry into the field almost sixty years ago provincial legislatures have consistently accorded much attention to the securities market as is demonstrated by the virtually continuous process of amendment to and revision of the provincial acts.[34] Not surprisingly, the legislation has also been the subject of consideration by the courts which have made clear that the provinces have extensive powers to regulate trading in securities.[35]

The provinces have enacted securities legislation under their authority to legislate in relation to "Property and Civil Rights in the Province" which has been interpreted to include contracts, dealings with property and the regulation of businesses, trades and professions.[36] Provincial power in relation to the securities market in particular has been generously interpreted by the courts. In 1932 the Privy Council upheld the Alberta Security Frauds Prevention Act, 1930,[37] as a valid exercise of provincial jurisdiction intended to protect local investors from fraudulent practices[38] and the case, now the leading decision in the field, has been broadly read so that in most instances in which a question concerning the validity of a securities act has arisen, the provincial legislation has been upheld.[39] Judicial sympathy for provincial securities legislation is reflected even more dramatically in a number of decisions which held that no conflict exists between federal legislation and overlapping provisions in the securities acts.[40]

33 *See e.g. supra* notes 30, 31 and accompanying text.

34 The first securities act enacted in Canada was the Sale of Shares Act, S.M. 1912, c. 75; *see also* R.S.M. 1913, c. 175. For the history of Canadian securities legislation until 1966, *see* J. WILLIAMSON, ch. 1; J. WILLIAMSON, SUPP., ch. 1. Since 1966 the amount of legislative attention paid to securities has, if anything, increased; *see e.g.* P. ANISMAN at 4-8. And *see* the recent efforts in Ontario to replace the present "uniform act" with a new one; Ontario Bill 154; Bill 75; Bill 98; Bill 20; Bill 30; and Bill 7. Bill 7 received third reading on June 23, 1978.

35 *See generally* P. HOGG, *supra* note 32, at 312-13; LASKIN'S CANADIAN CONSTITUTIONAL LAW 359-61 (4th ed. rev., A. Abel ed. 1975) [hereinafter cited as LASKIN]; J. WILLIAMSON, ch. 7; J. WILLIAMSON, SUPP., ch. 7; *see also* KIMBER REPORT, pt. IX.

36 British North America Act, 30 & 31 Vict., c. 3, s. 92(13) (1867) [hereinafter cited as BNA Act]. On the interpretation of the section, *see* P. HOGG, *supra* note 32, ch. 17.

37 S.A. 1930, c. 8. The act required persons trading in securities to obtain a licence as a broker or salesman and granted extensive powers of investigation.

38 Lymburn v. Mayland, [1932] A.C. 318 (P.C.).

39 *See e.g.* Re Thodas, 10 C.R.N.S. 290 (B.C.C.A. 1970); International Claim Brokers Ltd. v. Kinsey, 57 D.L.R. (2d) 357 (B.C.C.A. 1966); Woodson v. Russel, [1961] Que. Q.B. 349 (C.A. 1959); Re Williams, 29 D.L.R. (2d) 107 (Ont. C.A. 1961).

40 *See* Duplain v. Cameron, [1961] S.C.R. 693 (requirement that issuer of promissory notes register not in conflict with Bills of Exchange Act); Smith v. R., [1960] S.C.R. 776 (offence for misrepresentation in prospectus not in conflict with false prospec-

The reluctance of the courts to strike down provincial securities legislation likely stems in part from the fact that there is no federal securities law so that a declaration of the invalidity of a provincial act or any of its provisions would create a potential gap in the existing regulatory scheme that might be exploited by the unscrupulous.[41] This unstated influence is manifest in the famous *McKenzie Securities* case in which a broker-dealer registered in Ontario was held to have violated the Manitoba Securities Act by trading in Manitoba without registration;[42] the trading consisted of solicitations made from Ontario to Manitoba residents by means of telephone calls and letters. As the activities in question were clearly interprovincial, the court felt constrained to demonstrate that the impact of the conduct was felt in Manitoba and was, therefore, within the Manitoba Act[43] and found it necessary to support this conclusion with the assertion that securities legislation is "not in the nature of marketing legislation";[44] as a result it was reasonable to conclude that it was not "designed in any way for the regulation of interprovincial trading" and had no extra-provincial effects.[45]

It is not surprising that the Supreme Court of Canada denied an application for leave to appeal the decision[46] for the Manitoba Court of Appeal in its refusal to analogize the Act to marketing legislation had relied expressly on a dictum of the Supreme Court in a decision made the year before involving the converse fact situation. In *Gregory & Company Inc. v. QSC* the Supreme Court of Canada upheld the application of the Quebec Securities Act to a broker-dealer in Québec who traded only with clients outside the province, in fact, outside the country.[47] As the constitutional issue

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tus section of Criminal Code); Malczewski v. Sansai Securities Ltd., 49 D.L.R. (3d) 629 (B.C.S.C. 1974) (condition on registration requiring deposit in trust fund for benefit of clients in event of bankruptcy neither in relation to bankruptcy nor in conflict with Bankruptcy Act); Gregory Company Inc. v. Imperial Bank of Canada, [1960] Que. S.C. 204 ("freeze order" under Québec Securities Act applicable to registrant's account in bank). *But see* Multiple Access Ltd. v. McCutcheon, 16 O.R. (2d) 593 (Div'l Ct. 1977), *affirmed*, (Ont. C.A. June 14, 1978, unreported). The paramountcy doctrine is discussed *infra* ch. III.H.

41 *See e.g.* LASKIN, *supra* note 35, at 360; P. HOGG, *supra* note 32, at 313.

42 R. v. W. McKenzie Securities Ltd., 56 D.L.R. (2d) 56 (Man. C.A. 1966), *leave to appeal denied sub nom.* West v. R., [1966] S.C.R. ix.

43 *See id.* at 64. The key passage, which reflects a conflict of laws interest analysis more than a traditional constitutional analysis to determine whether the transaction is interprovincial or intraprovincial, is quoted and discussed in J. WILLIAMSON, SUPP. at 226-27.

44 56 D.L.R. (2d) at 61.

45 *Id.* at 62-63; *see also* R. v. Jaasma, [1974] 1 W.W.R. 245 (Alta. Prov. Ct. 1973). *Cf.* Moran v. Pyle National (Canada) Ltd., [1975] 1 S.C.R. 393 (1973).

46 *See* West v. R., [1966] S.C.R. ix.

47 Gregory & Company Inc. v. QSC, [1961] S.C.R. 584. For a discussion of the decision, *see* J. WILLIAMSON, SUPP. at 225-26.

was not properly raised, the matter was determined on the basis of the Act which expressly deemed such transactions to be made within the province.[48] Nevertheless, Mr. Justice Fauteux, writing for the majority, declared that securities legislation is not like marketing legislation, thus appearing to indicate that it is applicable to interprovincial transactions where some defined activity occurs in the province.[49] However, as has been indicated elsewhere, the statement is ambiguous and it is doubtful that he intended to say that a province can regulate interprovincial and international trading; more likely he meant that the Securities Act was directed only at conduct in the province whereas the marketing legislation necessarily involved consequences outside the province.[50] And it is clear that neither the Québec nor the Manitoba legislation precluded any person from trading in securities outside the province.

It is arguable on a conceptual basis that there is no difference between an interprovincial transaction in commodities and one in securities and that the *McKenzie* case is inconsistent with the principles espoused in the marketing decisions of the Supreme Court.[51] Moreover, it has been cogently argued that the decision would permit a province to close its borders to nonresident brokers and dealers, for if "Manitoba refuses to register nonresidents, then the province has shut off interprovincial trading across its borders".[52] Nevertheless, as long as no federal legislation exists to regulate interprovincial trading in securities, it is doubtful that the approach reflected in *Gregory* by Mr. Justice Fauteux and in

48 *See* Quebec Securities Act, s. 50.

49 [1961] S.C.R. at 590; *see also supra* text accompanying notes 44, 45.

50 *See* J. Williamson, Supp. at 226. The same point was made in R. v. W. McKenzie Securities Ltd., 56 D.L.R. (2d) at 62. And *cf.* Cowen v. A.G.B.C., [1941] S.C.R. 321. *See also* the concurring opinion of Cartwright, J., stressing that the *Gregory* case does not decide in any manner whatever the constitutional validity of the Québec act, even while indicating some doubt about it; [1961] S.C.R. at 591-92. The Quebec Securities Commission has relied on *Gregory* to justify the application of the Quebec Securities Act to an issuer with its head office in Québec selling securities through a subsidiary exclusively outside the province; *see In re* Développement Morin Heights (Canada) Limitée, 9 QSC Bull., No. 26 (Decision 5593, June 14, 1978).

51 *See e.g.* A.G. Man. v. Man. Egg and Poultry Assn., [1971] S.C.R. 689; Burns Foods Ltd. v. A.G. Man., [1975] 1 S.C.R. 494; Reference re Farm Products Marketing Act, [1957] S.C.R. 198; and *see* P. Hogg, *supra* note 32, at 313 n. 112. *See also* Interprovincial Co-operatives Ltd. v. R., [1975] 5 W.W.R. 382, 390 (S.C.C. 1975) (where contract affects interprovincial trade, is no longer within provincial jurisdiction). *But see e.g.* Shannon v. Lower Mainland Dairy Products Bd., [1938] A.C. 708 (P.C.); Home Oil Distributors Ltd. v. A.G.B.C., [1940] S.C.R. 444; Carnation Company Ltd. v. Qué. Agricultural Marketing Bd., [1968] S.C.R. 238.

52 J. Williamson, Supp. at 227. *See also e.g.* Manitoba Securities Act, s. 14 (residence requirement). In fact the validity of the Ontario provisions relating to nonresident ownership of registrants has recently been questioned; *see* Anderson, *Reynolds to Appeal OSC Ruling*, The Globe and Mail (Toronto), March 22, 1978, at B4, col. 1.

McKenzie Securities will be reconsidered in any significant manner.

However, as the Kimber Committee recognized, there remain substantial limitations on provincial legislative jurisdiction arising "in the main, from the territorial restriction on all provincial law-making power, and from the interprovincial and, indeed, international character of the securities industry".[53] In fact the head of power which authorizes the enactment of securities laws by the provinces is explicitly limited to "property and civil rights *in the province*"[54] and a body of case law has demonstrated that this territorial limitation may be an impediment to effective provincial regulation.[55] For example, during the depression the Western provinces were held incapable of relieving resident debtors of some of their obligations where the scheme adopted involved impairment of the rights of creditors outside the enacting province.[56] More recently the Supreme Court of Canada adopted a similar analysis as a basis for declaring invalid a scheme adopted in Manitoba which would have governed the terms of a contract for the purchase of hogs in Saskatchewan.[57] Manitoba has also been held incompetent to create a statutory right of action against persons who discharge pollutants into rivers flowing into the province because it would, in effect, have destroyed rights to discharge granted by the province in which the polluter carried on its activities, including the discharge.[58]

These decisions indicate that a province's jurisdiction is limited to persons, property or activities within its borders and that the existence of some element in the province will not necessarily be sufficient to support regulatory legislation that modifies rights outside the province or that creates extraterritorial duties. Thus, despite *McKenzie Securities*, provincial legislation may in some circumstances be incapable of dealing adequately with securities transactions that involve interprovincial or international elements, especially in relation to enforcement problems.[58a] There has long been doubt, for example, over the validity of the warrant

53 Kimber Report ¶ 9.01.

54 BNA Act, s. 92(13) (emphasis added).

55 *See e.g.* P. Hogg, *supra* note 32, at 208 - 11.

56 *See* Credit Foncier Franco-Canadian v. Ross, [1937] 3 D.L.R. 365 (Alta. App. Div.); *see also* Royal Bank of Canada v. The King, [1913] A.C. 283 (P.C.); Ottawa Valley Power Co. v. Hydro Elec. Power Commn., [1937] O.R. 265 (Ont. C.A.); Beauharnois Light, Heat and Power Co. v. Hydro Elec. Power Commn., [1937] O.R. 796 (Ont. C.A.). The approach in these decisions has been questioned; *see* P. Hogg, *supra* note 32, at 209-10.

57 Burns Foods Ltd. v. A.G. Man., 40 D.L.R. (3d) 731, 736-37 (S.C.C. 1973).

58 Interprovincial Co-operatives Ltd. v. R., [1976] 1 S.C.R. 477, [1975] 5 W.W.R. 382.

58a *See e.g.* Baillie and Alboini, *The National Sea Decision - Exploring The Parameters of Administrative Discretion*, 2 Can. Bus. L.J. 454 (1978).

backing provisions contained in all the provincial securities acts[59] because of a decision holding an analogous procedure an "attempt to give extra-provincial effect to proceedings under" a provincial statute.[60] A more recent decision held the effect of a cease trading order issued under the British Columbia Securities Act to be limited to the province so that it did not preclude transactions in Ontario for the account of a British Columbia registrant.[61] As a result a Vancouver registrant was not able to obtain securities to cover a short sale to an Ontario registrant which then purchased the securities at a price resulting in a substantial loss to the former registrant's client. Mr. Justice Anderson viewed the case as an example which

> "points up the drastic results which can flow from the lack of a federal regulatory agency or, alternatively, the lack of joint action by the provincial regulatory bodies. It seems obvious that one of the results of the prohibitory orders was to dry up the supply of shares (capable of delivery) in British Columbia and, thereby, force up the market in Ontario."[62]

The distortive effects of a cease trading order made in one province where trading in the securities that are subject to it continues in other provinces have also been felt in Ontario.[63]

The regulatory problems facing provincial legislatures as a result of the territorial limitations on their legislative authority are highlighted by recent events and legislation relating to takeover bids. The recent acquisition of shares in Husky Oil Limited by Alberta Gas Trunk Line Company has caused some stir in Canada.[64] Because the shares were purchased on the American Stock Exchange in a manner that would not be permitted under the rules of the Toronto Exchange,[65] on which the shares are also listed, and because the proposed Ontario legislation expressly legitimates the Canadian exchange's approach,[66] it has been suggested that Ontario investors were deprived of a fair opportunity to sell their shares in Husky Oil at the prices paid in the United States.[67] In fact the Ontario Securities Commission has stated that

59 *See e.g.* Ontario Securities Act, s. 149; *see also* J. WILLIAMSON at 208.

60 *Ex parte* Eli, [1920] 1 W.W.R. 661, 662 (Alta. S.C.).

61 Black v. Doherty McCuaig Ltd., [1974] 4 W.W.R. 342 (B.C.S.C.).

62 *Id.* at 344.

63 *See e.g. In re* Bralorne Resources Limited, [1976] OSC Bull. 258 (September), discussed *supra* text accompanying note 11.

64 *See supra* text accompanying notes 15, 16.

65 *See supra* note 15.

66 *See* Ontario Bill 7, s. 88(2)(a).

67 *See* Pritchard, *OSC Upset Small Holder Was Left Out*, The Globe and Mail (Toronto), June 30, 1978, at B1, col. 2. The apprehended unfairness appears to ignore the fact that Ontario investors had an opportunity to sell their shares on the American

it is considering whether the Ontario cabinet has authority to limit the exemption from the takeover bid requirements to exchanges which have "stock exchange takeover bid" rules like those of the Canadian exchanges.[68] It is, however, reasonably clear that Ontario lacks jurisdiction to impose its statutory scheme for takeover bids on a person who purchases on an exchange outside the country, even if the corporation the shares of which are sought is listed on the Toronto Exchange.[69]

One of the major innovations in Ontario Bill 7 demonstrates the difficulties inherent in any attempt to develop a national regulatory scheme through uniform provincial legislation. The proposed legislation will require a person who buys a control block of shares at a premium above the market price[70] to make an equivalent offer to purchase the shares of the remaining shareholders.[71] As such an offer would be ineffective if made only to shareholders in Ontario, the bill requires that the offer be made to all securityholders of the same class whose last registered address

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Stock Exchange at the inflated prices resulting from the announced bids and that the prices on the Toronto Exchange were also affected by the announcements. Indeed, the president of Alberta Gas Trunk Line has stated that over 90% of the independent Husky shares were held by arbitrageurs in New York which indicates that many Ontario investors had likely taken advantage of the opportunity to sell on the market; *see* Lukasiewicz, *AGTL Chief Claims Concern Has No Basis*, The Globe and Mail (Toronto), July 4, 1978, at B3, col. 3. And it is likely that many of those who did not so sell held their shares in the expectation that either Petro-Canada or Occidental Petroleum would make a takeover bid at an even higher price; *see* Pritchard, *Husky Share Price Takes Sharp Drop As Trade Resumed*, The Globe and Mail (Toronto), July 1, 1978, B1, col. 1 at col. 2. In short, it is questionable whether Ontario investors were deprived of any opportunities other than as a result of the Toronto Stock Exchange rules which precluded open market purchases otherwise permissible under Canadian legislation. If any party suffered from the transaction it was Petro-Canada which conducted itself in an open manner and as a result was precluded by U.S. law from countering the market purchases of Alberta Gas, even though it would have been permitted to do so under the Canadian legislation; *see* Securities Exchange Act of 1934, Rule 10b-13; *cf.* Canada Business Corporations Act, ss. 190(e), (f).

68 *See* Pritchard, *OSC Upset Small Holder Was Left Out*, *supra* note 67.

69 *See supra* text following note 58 and authorities cited in notes 57, 61. In any event, Ontario Bill 7 does not clearly include such an offer as a "takeover bid" because it is not made to Ontario residents and because the other elements of the definition are presumably limited territorially so that only an acceptance of an offer to sell by a person in Ontario is covered; *see* Ontario Bill 7, s. 88(l)(k). In fact, the definition is arguably so confined expressly as an acceptance is deemed to be an offer to purchase and only offers made to Ontario residents are within the definition; *id.* ss. 88(l)(k)(i), (ii). Although it might be argued that an offer made on a U.S. stock exchange is made to Ontario investors, it is at best doubtful whether the argument would succeed.

70 *See* Ontario Bill 7, ss. 88(l)(e) and (k), defining "market price" and "takeover bid"; the latter definition is framed in terms of an acquisition of shares that brings an offeror's holdings in the issuer over 20%.

71 *Id.* s. 91(1).

"is in Ontario or in a uniform act province".[72] In order to facilitate this result neither the definition of "takeover bid" nor that of "offeror" is expressly limited to the province.[73] It is likely, however, that the section would be characterized as merely imposing a duty on a local offeror, especially if it is read as applicable only to acceptances in Ontario.[74] While such an interpretation may be necessary to the provision's validity,[74a] it would be inconsistent with the other part of the section dealing with normal takeover bids made to Ontario offerees by any offeror;[74b] and, more importantly, it would necessarily be ineffective because of its failure to cover non-Ontario offerors. Indeed, it might even act as a deterrent to Ontario offerors by creating an advantage for foreigners. In short, if the provision is read down to avoid any extraterritorial application, even uniform legislation will not be sufficient to catch all purchases of control.

It is clear, therefore, that the limitations on provincial jurisdiction not only cast doubt on the ability of the provincial commissions to enforce their own acts in connection with interprovincial and international transactions but also on the ability of the provinces, even acting cooperatively, to enact a scheme that will satisfactorily regulate the entire securities market. It goes without saying that similar restrictions do not apply to the federal government's ability to legislate;[75] indeed, it is clear that Parliament may enact legislation with extraterritorial impact.[76]

A further limitation on provincial power to regulate the secur-

72 *Id. See also* Ontario Bill 7, s. 129 (person who fails to make takeover bid liable to pay "to the securityholders entitled to receive the offer" the amount at which the bid required to be made). Given the policy implicit in the Bill, even the requirement that the offer be made to securityholders in a uniform act province is an unsatisfactory halfway measure for unless all of the other provinces adopt the Ontario Bill, the offeror may still exclude some of the minority shareholders; on a policy basis, therefore, it would have been preferable to have required the offer to be made at least to all shareholders resident in Canada.

73 Indeed, it is arguable that the effect of the Bill is to require that offers be made to securityholders outside the province and that the provision is, therefore, beyond provincial jurisdiction in that it necessitates interprovincial transactions; *see infra* ch. III.B.1; and *cf. supra* text accompanying notes 53-58; *but see supra* text accompanying notes 42-52 and following.

74 *See supra* note 69 and *infra* note 407 ("reading down"). If the presumed "offer to purchase" of Ontario Bill 7, s. 88(l)(k)(ii) is, as is suggested *supra* in note 69, limited to Ontario offerees under *id.* s. 88(l)(k)(i), then the provisions would exclude as well a purchase by an Ontario offeror from non-Ontario shareholders and would apply only to purchases from local offerees by local offerors.

74a *See supra* text accompanying notes 53-58.

74b *See* Ontario Bill 7, s. 88(l)(k)(i) ("takeover bid"); *see also* P. ANISMAN at 43.

75 *See e.g.* Interprovincial Co-operatives Ltd. v. R., [1975] 5 W.W.R. 382, 390 (S.C.C.) (basic principle that what is beyond provincial authority is within federal, *per* Pigeon, J.).

76 *See* Statute of Westminster, 1931 (Imp.), R.S.C. 1970, app. III, No. 26, s. 3; Croft v. Dunphy, [1933] A.C. 156 (P.C.); P. HOGG, *supra* note 32, at 206-07.

ities market results from the special status accorded federal corporations.[77] A long line of well-known decisions has consistently held that a province lacks jurisdiction to interfere with the status or capacity of a federally created entity, for example, by precluding it from carrying on business in the province.[78] Not surprisingly, the doctrine was early applied to provincial regulation of new issues of securities of federal corporations; in 1923 the Supreme Court of Canada declared the Saskatchewan Sale of Shares Act[79] *ultra vires* the province in so far as it affected federal companies[80] and its conclusion was in effect affirmed by the Privy Council six years later.[81] The basis of both decisions was that the raising of capital was so essential to the functioning of a corporation that any legislation precluding it from doing so impaired its status and capacity "in a substantial degree".[82] Although the legislation under consideration in both cases involved a "blue sky" discretion exercisable by a provincial official, the reasoning does not appear to turn on the discretionary power to refuse to accept a prospectus but rather on the fact that the statutes imposed a prerequisite failure to comply with which would result in a prohibition against the sale of its shares by a federal corporation.[82a]

77 *See e.g.* KIMBER REPORT ¶¶ 9.01, 9.07.

78 *See* John Deere Plow Co. Ltd. v. Wharton, [1915] A.C. 330 (P.C.); Great West Saddlery Co. Ltd. v. R., [1921] 2 A.C. 91 (P.C.). Although these are the leading cases on the subject, the doctrine originated in a dictum of Sir Montague Smith in Citizens Insurance Company of Canada v. Parsons, 7 A.C. 96, 113-14 (P.C. 1881). For the most recent statement of the doctrine, *see* Canadian Indemnity Co. v. A.G.B.C., 73 D.L.R. (3d) 111, 118-22 (S.C.C. 1976). *See also* Ziegel, *Constitutional Aspects of Canadian Companies*, in STUDIES IN CANADIAN COMPANY LAW 149 (J. Ziegel, ed. 1967).

79 R.S.S. 1920, c. 199.

80 Lukey v. Ruthenian Farmers Elevator Co., [1924] S.C.R. 56, [1924] 1 D.L.R. 706 (1923).

81 A.G. Man. v. A.G. Can., [1929] A.C. 260 (P.C. 1928) (Sale of Shares Act, S.M. 1924, c. 175; Municipal and Public Utility Board Act, S.M. 1926, c. 33, ss. 162-78). These decisions are discussed more fully in J. WILLIAMSON at 196-200; P. Anisman, The Person-Company Dichotomy in the Ontario Securities Act: The Problem of the Dominion Company, unpublished paper at the University of Toronto, on file at Corporate Research Branch, Consumer and Corporate Affairs Canada (1967).

82 *See* A.G. Man. v. A.G. Can., [1929] A.C. at 268; Lukey v. Ruthenian Farmers Elevator Co., [1924] 1 D.L.R. at 707 (*per* Davies, C.J.), 714-15 (*per* Duff, J.) and 718 (*per* Mignault, J.).

82a *See e.g.* A.G. Ont. v. Winner, [1954] A.C. 541, 578 (P.C.).

It may be possible to interpret the Privy Council's decision in terms of the discretionary powers of the administrators to refuse to accept a prospectus as some commentators have; *see e.g.* Leigh and Whyte, *Two Recent Cases Concerning the Validity of Commodity Marketing Legislation*, 24 U. TORONTO L.J. 411, 420 (1974); *cf.* Re Royalite Oil Co., [1931] 2 D.L.R. 418, 430 (Alta. C.A.) (unfettered discretion to require information enables imposition by provincial administrator of incapacitating condition, *per* Harvey, C.J.A.). Even Chief Justice Harvey, however, adopted a stronger position on the validity of prospectus requirements, *id.* at 432, which may reflect the inevitability of the exercise of discretion by an administrator with jurisdiction to review even the adequacy of disclosure in a prospectus. In any event, the distinction is not material for present purposes as all of the provincial securities

Nevertheless, even a strong reading of the decisions does not preclude all provincial regulation of primary distributions by federal corporations. It would at least be permissible for a province to require such an issuer to file information so long as its ability to sell shares is not conditional on the filing.[83] Moreover, a federal corporation may be precluded from raising capital through an underwriter who is not registered in the province so long as there are registered underwriters who might act for it.[84] However, it is worth reiterating that *Lymburn v. Mayland*, the leading decision upholding provincial securities legislation and the decision on which the preceding sentence is based, upheld a statute that did not contain prospectus provisions and that, in fact, imposed no duties on corporate issuers.[85] The prospectus provisions in the present provincial securities acts, all of which require that a prospectus be accepted by an administrator who is granted a "blue sky" discretion to refuse,[86] are of questionable validity with respect to federal corporations.[87] Indeed, the doubt concerning these provisions has been reinforced in recent decisions of the Supreme Court reaffirming the vitality of the *Manitoba* decision[88] and extends to other provisions of the provincial acts as well, for example, those dealing with proxy solicitations.[89]

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acts grant a residual blue sky discretion to the commissions; *see infra* notes 86, 87 and accompanying text.

83 In fact, Ontario early enacted legislation requiring that specified information be filed by every public company "upon the sale in Ontario of any of its securities", presumably as a result of the *Lukey* decision; *see* Companies Information Act, 1928, S.O. 1928, c. 33, s. 3(l)(b).

It is also arguable that a prospectus may be required of a federal corporation the business of which involves the issue and sale of hybrid securities such as interests in land or interests in silver coins which constitute investment contracts, *see e.g.* Pacific Coast Coin Exchange of Canada v. OSC, 80 D.L.R. (3d) 529 (S.C.C. 1977); *In re* Développement Morin Heights (Canada) Limitée, 9 QSC Bull., No. 26 (Decision 5593, June 14, 1978), as the sale of such securities is in reality the conduct of the issuer's business rather than the raising of capital necessary for it to function at all; the latter type of distribution alone was considered in the *Manitoba* and *Lukey* decisions.

84 *See e.g.* Lymburn v. Mayland, [1932] A.C. 318; *see also In re* Kleena Kleene Gold Mines Ltd., B.C. Corporate, Financial and Regulatory Services Weekly Summary, July 22, 1977, at 5 (Corp. and Financial Services Commn.). *Cf.* Hretchka v. A.G.B.C., [1972] S.C.R. 119 (1971) (provincial legislation applicable to secondary distribution of shares of federal corporation); and *see* KIMBER REPORT ¶ 9.07.

85 *See* P. Anisman, *supra* note 81, at 42-43.

86 *See e.g.* Ontario Securities Act, s. 61; Ontario Bill 7, s. 60.

87 *See* J. WILLIAMSON, SUPP. at 229-30; P. Anisman, *supra* note 81, at 43-47.

88 *See* Canadian Indemnity Co. v. A.G.B.C., 73 D.L.R. (3d) 111, 122 (S.C.C. 1976). Mr. Justice Martland, speaking for the Court, concurred in a dictum of the Chief Justice, quoted *id.* at 118, from Morgan v. A.G.P.E.I., [1976] 2 S.C.R. 349, 365, 55 D.L.R. (3d) 527, 539 (1975). It is reasonable, therefore, to conclude that Martland, J., no longer holds to his seemingly contrary dictum in Hretchka v. A.G.B.C., [1972] S.C.R. 119, 127 (1971)

89 *See e.g.* KIMBER REPORT ¶ 9.07; P. Anisman, *supra* note 81, at 48, arguing that such

In summary, it is fair to say that limitations on provincial legislative jurisdiction may create serious impediments to pervasive regulation of the Canadian securities market by the provinces. Despite their having filled an otherwise regulatory void, particularly by cooperative efforts which have been accelerated in recent years, it appears that some form of federal legislation to ensure a comprehensive scheme of securities regulation in Canada is warranted.[90]

Chapter III
Federal Jurisdiction over Securities

A. NATURE OF FEDERAL LEGISLATION

Any modern securities act must deal with a number of areas each of which is essential to a comprehensive scheme of securities regulation. One of the basic techniques for enhancing investor confidence, for example, is to ensure the disclosure by issuers of information adequate to enable rational investment decisions to be made both in connection with new issues of securities and in the secondary market.[91] Such disclosure has usually been imposed by means of a prospectus requirement for primary and secondary distributions[92] and, especially recently, by means of continuing disclosure requirements applicable to issuers the securities of which are actively traded as a result of having been distributed or listed on a stock exchange.[93] In most schemes regular reporting by issuers is supplemented by provisions requiring disclosure in connection with the solicitation of proxies[94] and with takeover

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provisions might be held to interfere with the constitution of a federal corporation and citing Citizens Insurance Company of Canada v. Parsons, 7 A.C. 96, 113-14 (P.C. 1881); Lukey v. Ruthenian Farmers Elevator Co., [1924] 1 D.L.R. 706, 712-13 (*per* Duff, J.); *see also* Ziegel, *supra* note 78, at 170-71; Multiple Access Ltd. v. McCutcheon, 78 D.L.R. (3d) 701, 708 (Ont. Div'l Ct. 1977), *affirmed*, (Ont. C.A. June 14, 1978, unreported).

90 *See e.g.* SPECIAL JOINT COMMITTEE OF THE SENATE AND OF THE HOUSE OF COMMONS ON THE CONSTITUTION OF CANADA, FINAL REPORT, ch. 34 (1972). In fact, the limitations on provincial authority alone indicate that jurisdiction to legislate in relation to the securities market is concurrent; *see supra* note 75. *See also supra* ch. I.

91 *See generally e.g.* KIMBER REPORT ¶¶ 4.01-4.06; REPORT OF THE ADVISORY COMMITTEE ON CORPORATE DISCLOSURE TO THE SEC; WHEAT REPORT; and *see*, *Grover & Baillie*.

92 *See e.g.* Ontario Securities Act, ss. 35-57; Securities Act of 1933; and *see* Ontario Bill 7, ss. 51-59, 61; ALI FEDERAL SECURITIES CODE, pt. 5.

93 *See e.g.* Ontario Securities Act, pt. XII; Securities Exchange Act of 1934, s. 12; and *see* Ontario Bill 7, pt. XVII; ALI FEDERAL SECURITIES CODE, s. 602.

94 *See e.g.* Ontario Securities Act, pt. X; Securities Exchange Act of 1934, s. 14(a); *see also* Ontario Bill 7, pt. XVIII; ALI FEDERAL SECURITIES CODE, s. 603.

bids[95] and reporting of transactions by insiders.[96] Any federal legislation to be effective must contain similar requirements and would likely contain as well substantive provisions and discretionary powers necessary to supplement them such as a discretion in an administrator to refuse a prospectus on the basis of the merits of the securities offered under it.[97]

The other basic technique of regulation associated with securities laws is the licensing of market actors such as brokers, dealers, advisers and underwriters, in order to ensure their integrity, competence and financial stability.[98] As most market actors are today members of a self-regulatory organization, whether it be a stock exchange or association of brokers or dealers, which itself supervises their conduct and capital position, the legislative schemes in essence provide a standard against which to evaluate the performance of the self-regulatory organizations and a spur to the effective performance of their supervisory functions over their members. The self-regulatory organizations not only supervise their members' activities but also themselves establish standards for entry into the market, the rates at which business is conducted by their members and even set standards for trading and supervise the market in order to ensure its fair operation.[99] As a result, securities regulators have been required increasingly to supervise the self-regulatory organizations themselves so that the self-regulators will not be overzealous in protecting their members from competition or even in protecting the public by action unfair to their members.[100] It is clear that any federal act must deal with the

95 *See e.g.* Ontario Securities Act, pt. IX; Securities Exchange Act of 1934, s. 14(d); Ontario Bill 7, pt. XIX; ALI Federal Securities Code, ss. 606-607. On the regulation of takeover bids generally, *see* P. Anisman, which indicates the integrated nature of securities regulation even in connection with a subject as seemingly restricted as takeover bids.

96 *See e.g.* Ontario Securities Act, pt. XI; Securities Exchange Act of 1934, ss. 13(d), 16(a); and *see* Ontario Bill 7, pt. XX; ALI Federal Securities Code, ss. 605, 607. *See also, Yontef*, ch. II; *Anisman* at 181-201.

97 *See e.g. Grover & Baillie*, chs. V.A, VI.C, VII.B. Such a discretion is important in a federal law as it would fill a gap at present beyond provincial jurisdiction; *see supra* text accompanying notes 78-82. For examples of substantive requirements relating to takeover bids, *see* Canada Business Corporations Act, ss. 188-90; and *see* P. Anisman, ch. IV.

98 *See generally, Connelly.* In fact the provincial legislation upheld in Lymburn v. Mayland, [1932] A.C. 318 (P.C.), was exclusively directed at the registration of brokers and dealers; *see supra* note 37. *See also e.g.* Ontario Bill 7, pt. X; ALI Federal Securities Code, pt. VII.

99 *See generally, Dey & Makuch.*

100 *See id.; see also e.g.* P. Anisman, Antitrust and the New York Stock Exchange: A Challenge for Self-Regulation, unpublished paper at the University of California, Berkeley, on file at Corporate Research Branch, Consumer and Corporate Affairs Canada (October 19, 1968). And *see e.g.* Ontario Securities Act, ss. 30-31, 140-41; Ontario Bill 7, pts. VIII-IX; ALI Federal Securities Code, pt. VIII.

self-regulatory bodies[101] and likely that it will in one way or another contain supervisory powers over other market actors too.[102]

The Criminal Code now prohibits several types of market manipulation and other fraudulent conduct in connection with securities transactions.[103] A federal act to regulate the securities market would likely incorporate the prohibitions now in the Criminal Code and add a number of other prohibitions directed at fraudulent and deceptive practices in securities[104] and might include as well a number of supplementary provisions relating to the conduct of market actors.[105] Violation of all such provisions would, of course, invoke criminal penalties; and as securities regulation is essentially remedial it would be surprising indeed if a federal act did not provide for civil liability to enable investors who suffer harm to obtain a remedy.[106]

All of these types of provisions necessitate some sort of body for their administration and enforcement. Any federal legislation will, therefore, undoubtedly authorize some sort of administrative body to administer its provisions and will grant it investigative and other enforcement powers to enable it to do so.[107] In light of the national character of the market, it may also be advisable to provide for delegation of the administration of a federal act to a provincial commission and to authorize the federal body to accept a similar delegation from a province, a device frequently used in the past to establish cooperative regulatory schemes.[108]

Although the ultimate goals of all securities laws are essentially the same and although all of the elements outlined above would form parts of a single, comprehensive scheme for the regula-

101 Especially as one of the major developments necessitating federal regulatory involvement is inextricably associated with the self-regulatory bodies; *see supra* text accompanying notes 9-12 and following. And *see infra* ch. III.C.

102 Federal regulation of market actors is discussed *infra* text accompanying notes 203-13.

103 *See* Criminal Code, ss. 338 (fraud affecting public market), 340 (wash trading), 341 (bucketing), 342 (broker gambling against client) and 358 (false prospectus); and *see generally, Leigh*, ch. II.A.

104 *See e.g.* Ontario Securities Act, ss. 100, 137; Ontario Bill 7, ss. 75, 118; ALI Federal Securities Code, pt. XVI. And *see generally, Leigh*, ch. II.

105 The legislation might, for example, establish the duties owed by a securities firm to its clients; *see e.g.* Ontario Securities Act, pt. VIII; Ontario Bill 7, pt. XII; ALI Federal Securities Code, ss. 910, 913-15.

106 *See e.g.* Ontario Securities Act, ss. 100a, 113, 142; Ontario Bill 7, pt. XXII; ALI Federal Securities Code, pt. XVII; and *see generally, Leigh*.

107 *See e.g.* Ontario Securities Act, pts. I, III, IV, XIII, XIV; Ontario Bill 7, pts. I-VI, XXI; ALI Federal Securities Code, pt. XVIII.

108 *See e.g.* P.E.I. Potato Marketing Bd. v. H.B. Willis Inc., [1952] 2 S.C.R. 392; Reference re Agricultural Products Marketing Act, 19 N.R. 361 (S.C.C. 1978). Interdelegation is discussed *infra* ch. III.I.

tion of the Canadian securities market, each of them may be treated separately in the legislation and each of them may, as a result, raise somewhat different constitutional questions. In fact it may be possible to base different aspects of the scheme on different heads of federal power and such considerations may influence the structure of the scheme itself. It is worth pointing out initially that there is no decision holding that Parliament lacks jurisdiction to enact legislation regulating the securities market.[108a] The remainder of this paper, therefore, will discuss the legislative authority of Parliament which may provide a basis for a federal securities act both generally and in relation to particular parts that are likely to be included in the act and that may give rise to specific constitutional issues.

B. THE TRADE AND COMMERCE POWER

In view of the nature and function of the securities market the most obvious head of federal jurisdiction is subsection 91(2) of the BNA Act which authorizes Parliament to make laws in relation to the "Regulation of Trade and Commerce".[109] The font of judicial consideration of this provision once again[109a] is the *Parsons* decision of the Privy Council which indicated somewhat tentatively the boundaries of federal power under it.[110] In upholding provincial legislation regulating the terms of fire insurance contracts the Judicial Committee considered the federal power and concluded that it was intended to deal with matters of general concern to the nation[111] and that it did not, therefore, "comprehend the power to regulate by legislation the contracts of a particular business or

108a The Supreme Court of Canada has held, however, that Parliament may regulate transactions in the securities of federal corporations; *see* Esso Standard (Inter-America) Inc. v. J.W. Enterprises Inc., [1963] 2 S.C.R. 144, 152; *cf.* Multiple Access Ltd. v. McCutcheon, 78 D.L.R. (3d) 701 (Ont. Div'l Ct. 1977), *affirmed* (Ont. C.A. June 14, 1978, unreported) (jurisdiction assumed, 78 D.L.R. (3d) at 703); and *cf.* Canada Business Corporations Act, pt. VI (securities transfers).

109 For a general discussion of the trade and commerce power, *see* P. Hogg, *supra* note 32, ch. 15; A. Smith, The Commerce Power in Canada and the United States (1963) [hereinafter cited as A. Smith].

109a *See supra* note 78.

110 Citizens Insurance Company of Canada v. Parsons, 7 A.C. 96, 112-13 (P.C. 1881). Indeed even today decisions dealing with matters of trade and commerce usually begin analysis with this case; *see e.g.* A.G. Man. v. Man. Egg & Poultry Assn., [1971] S.C.R. 689, 701, 723; MacDonald v. Vapour Canada Ltd., 66 D.L.R. (3d) 1, 21-23 (S.C.C. 1976); R. v. Dominion Stores Ltd., 79 D.L.R. (3d) 627, 629 (Ont. H.C. 1977), *affirmed*, 83 D.L.R. (3d) 266 (Ont. C.A. 1978).

111 7 A.C. at 112 ("the collocation of No. 2 with classes of subjects of national and general concern affords an indication that regulations relating to general trade and commerce were in the mind of the legislature, when conferring this power on the dominion parliament").

trade, such as the business of fire insurance in a single province".[112] While expressly refraining from any attempt to define precisely the limits of federal authority, the committee stated that it included "regulation of trade *in matters of interprovincial concern* and...general regulation of trade affecting the whole dominion".[113]

1. *Interprovincial Trade and Commerce*

During the subsequent fifty years, however, the Privy Council, instead of attempting to strike a balance between the powers of Parliament and the provincial legislatures based on the flexible approach adopted in *Parsons*, consistently restricted the scope of federal legislative authority.[114] In brief, by 1926 subsection 91(2) had been effectively deprived of its status as an independent head of power and relegated to service as a mere aid to jurisdiction granted to Parliament by other heads or under its residual powers.[115] This restrictive approach was reflected in decisions precluding Parliament from regulating particular trades or businesses, whatever their scope or economic significance, by means of a licensing system[116] and generally from regulating transactions or works within a province that were part of such trades or businesses, even if over 80% of the commodity in question was destined for international trade.[117] Despite some resilement in subsequent opinions of the Committee from the excesses of principle embodied in these decisions,[118] their practical effects continued. Indeed, the courts continued to strike down federal schemes

112 *Id.* at 113.

113 *Id.* (emphasis added). The precise holding of the Privy Council is analyzed in A. Smith, *supra* note 109, ch. 3; *see also* A.G. Man. v. Man. Egg & Poultry Assn., [1971] S.C.R. 689, 723 (*per* Pigeon, J.).

114 The contraction and subsequent expansion of federal jurisdiction is described more fully elsewhere; *see e.g.* A. Smith, *supra* note 109; P. Hogg, *supra* note 32, ch. 15; *see also* W. McConnell, Commentary on the British North America Act 168-81 (1977); and *see* the pithy summary of Chief Justice Laskin in MacDonald v. Vapour Canada Ltd., 66 D.L.R. (3d) 1, 23-24 (1976).

115 *See In re* the Board of Commerce Act, 1919, [1922] 1 A.C. 191, 197-98 (P.C. 1921); Toronto Electric Commnrs. v. Snider, [1925] A.C. 396, 409-10 (P.C.).

116 *See e.g.* A.G. Can. v. A.G. Alta., [1916] 1 A.C. 588, 596 (P.C.) (licensing scheme for insurance companies).

117 *See* R. v. Eastern Terminal Elevator Co., [1925] S.C.R. 434, 444 (regulation of grain warehouses and elevators); *cf.* Canadian Industrial Gas & Oil Ltd. v. Sask., 80 D.L.R. (3d) 449, 456-57, 463 (S.C.C. 1977) (as 98% of oil produced in province destined for export, legislation establishing prices at well-head aimed at interprovincial trade and *ultra vires* the province).

118 *See e.g.* Proprietary Articles Trade Assn. v. A.G. Can., [1931] A.C. 310, 326 (P.C.). The Supreme Court of Canada too found the limitation created by Viscount Haldane unfounded; *see e.g.* Lawson v. Interior Tree Fruit & Vegetable Committee of Direction, [1931] S.C.R. 357, 367-70 (*per* Duff, J.).

of regulation that dealt primarily with interprovincial transactions if they included even incidentally transactions that were completed within a province.[119]

In the last thirty years, and particularly since the abolition in 1949 of appeals to the Privy Council,[120] Canadian courts have taken a more expansive view of what constitutes interprovincial and international trade and of the permissible scope of regulation dealing with it, without, however, denying or substantially modifying the essential practical limitations established in the earlier decisions.[121] This alteration of attitude has been manifested primarily in cases dealing with statutory schemes regulating trade in commodities. In the *Ontario Farm Products Marketing Reference*, the decision generally regarded as heralding a new approach, five judges of the Supreme Court indicated that federal jurisdiction would extend to transactions completed in a province which enter the flow of interprovincial trade.[122] Since then a number of decisions have reinforced the indications that a more realistic understanding of the implications of marketing schemes and the economics of interprovincial and international trade would be discernible in constitutional adjudication.[123] Nevertheless, the principled foundation of the decisions remains essentially the same as in those prior to 1939 and the holdings in many of the earlier cases would likely be the same today.[124]

It might be argued, therefore, that the Supreme Court's new approach to issues concerning trade and commerce is not as strikingly shown in its statements of principle as it is in decisions applying the principles to the elements of federal regulatory schemes which, although wholly within a province, must be cov-

119 *See e.g.* A.G.B.C. v. A.G. Can., [1937] A.C. 377 (P.C.).

120 *See* A.G. Ont. v. A.G. Can., [1947] A.C. 127 (P.C.) (Privy Council upheld power of Parliament to abolish appeals).

121 *See e.g.* Reference re Agricultural Products Marketing Act, 19 N.R. 361 (S.C.C. 1978); and *see e.g.* A. Smith, *supra* note 109, at 157 ("fresh approach").

122 Reference re the Farm Products Marketing Act, [1957] S.C.R. 198, 204-05, 209, 211, 231, 247; *cf.* Lawson v. Interior Tree Fruit Vegetable Committee, [1931] S.C.R at 365-66.

123 *See e.g.* Murphy v. Canadian Pacific Ry. Co., [1958] S.C.R. 626; A.G. Man. v. Man. Egg & Poultry Assn., [1971] S.C.R. 689; Burns Foods Ltd. v. A.G. Man., 40 D.L.R. (3d) 731 (S.C.C. 1973); Canadian Industrial Gas & Oil Ltd. v. Sask., 80 D.L.R. (3d) 449 (S.C.C. 1977); Reference re Agricultural Products Marketing Act, 19 N.R. 361 (S.C.C. 1978). *Cf. e.g.* Carnation Company Ltd. v. Que. Agricultural Marketing Bd., [1968] S.C.R. 238; and *cf.* R. v. Sommerville, [1974] S.C.R. 387 (1972).

124 *See e.g.* Canadian Indemnity Co. v. A.G.B.C., 73 D.L.R. (3d) 111, 116-18 (S.C.C. 1976) (even though insurance business "interprovincial and, indeed, international in scope", legislation regulating insurance business within provincial jurisdiction); *cf.* MacDonald v. Vapour Canada Ltd., 66 D.L.R. (3d) 1, 22 (S.C.C. 1976) ("*Parsons* case itself, on its facts, may even now be taken to have been correctly decided").

ered if the scheme is to work effectively.[125] Recently, for example, the Court upheld federal regulation of the sale of imported oil within Ontario as incidental to an extraprovincial marketing scheme intended to protect the domestic oil industry in Western Canada from foreign competition and as "an integral part of the control of imports in the furtherance of an extraprovincial trade policy".[126] In doing so the Court confirmed an increasing readiness to facilitate the working of valid regulatory schemes by a sympathetic application of constitutional principles[127] which it had indicated a number of years earlier by its refusal to accept an appeal from a decision holding a federal statute regulating the wheat trade applicable to a purely local feedmill as necessary to prevent avoidance of the scheme.[128]

Despite the breadth of the words used in *Parsons* to describe the scope of federal jurisdiction over interprovincial trade[129] and the Supreme Court's recent tendency to read life into them, the traditional and still dominant analytic approach, including the "flow of commerce" rubric, rests on a transactional analysis of the legislation – that is, on whether tangible goods or commodities physically cross a provincial border as a result of a transaction respecting them.[130] Although securities are chosen in action rather than tangible commodities, there is no apparent reason to treat interprovincial and international securities transactions otherwise than similar commodities transactions;[131] indeed both involve equally a transfer of rights pursuant to a contract from a person on one side of a provincial border to another on the other side.[132] Thus on a traditional analysis Parliament has the authority

125 For discussion of the "ancillary" doctrine, *see* Laskin, *supra* note 35, at 10-11, 100-01; P. Hogg, *supra* note 32, at 82 n. 21; and *see* Papp v. Papp, 8 D.L.R. (3d) 389, 393-95 (Ont. C.A. 1969).

126 Caloil Inc. v. A.G. Can., [1971] S.C.R. 543, 551 (1970); *see also* Capital Cities Communications Inc. v. CRTC, 81 D.L.R. (3d) 609, 623-24, 634-35 (S.C.C. 1977).

127 *See supra* note 125.

128 *See* R. v. Klassen, 20 D.L.R. (2d) 406 (Man. C.A. 1969), *leave to appeal denied*, [1959] S.C.R. ix (Wheat Board Act); *see also* Montana Mustard Seed Co. Inc. v. Continental Grain Co. (Canada) Ltd., 49 D.L.R. (3d) 72, 76-77 (Sask. C.A. 1974), *affirmed on other grounds*, [1976] 2 W.W.R. 768 (S.C.C. 1975) (licensing of grain dealers necessarily incidental to effectiveness of Canada Grain Act); and *see* R. v. Dominion Stores Ltd., 79 D.L.R. (3d) 627 (Ont. H.C. 1977), *affirmed*, 83 D.L.R. (3d) 266 (Ont. C.A. 1978).

129 *See supra* text accompanying note 113 ("matters of interprovincial concern").

130 This result is not too surprising as most legislation considered in the cases has involved schemes for the regulation of commodities. *See supra* cases cited in notes 115-17, 119, 121-23, 126. The decisions cited in notes 126 and 128 appear to be closer to the words used in *Parsons*; *see supra* note 129.

131 Indeed the movement toward treating securities as negotiable instruments would reinforce this result; *see e.g.* Canada Business Corporations Act, pt. VI; *cf.* BNA Act, s. 91(18) (negotiable instruments).

132 *See e.g. supra* cases cited in note 123; *see also* W. Hohfeld, Fundamental Legal Conceptions as Applied in Judicial Reasoning 30-31 (W. Cook, ed. 1964).

to regulate interprovincial and international trading in securities and has with the provinces concurrent jurisdiction over trading like that in the *McKenzie* and *Gregory* cases.[133]

Any scheme of regulation based on this approach would, as with marketing legislation, require provincial cooperation; Parliament might enact legislation regulating only interprovincial and international trading and the provincial acts would govern transactions in each province.[134] A federal act could thus require clearance of and establish disclosure and other requirements for distributions of securities that are international or interprovincial and for those by federal corporations.[135] As corporate securities are created and issued in the province in which an issuer is incorporated, it is arguable that all transactions in which the securities issued do not come to rest in the hands of an ultimate purchaser in the province of incorporation are interprovincial. In all such cases the securities cross a provincial border and involve at some point in the distribution an interprovincial transaction whether it be a trade with an underwriter or member of the underwriting group or a sale to an investor.[135a] By directing its legislation at such transactions Parliament can regulate all interprovincial and national new issues whether or not the province of incorporation or origin chooses to regulate the local trades made in the distribution, for the federal requirements would likely suffice to protect local investors as well. But provincial legislation would still be necessary to impose prospectus delivery requirements and civil liability for intraprovincial transactions – that is, for transactions completed in the originating province.[136]

Interprovincial trading, however, will not alone provide a sufficient basis for comprehensive federal legislation like that outlined above. While it may suffice for primary distributions and the imposition of continuing disclosure requirements on issuers who make them, it is less likely to prove adequate for secondary distributions which would tend more frequently to be intraprovincial. More important, the vast majority of secondary trading both on the exchanges and in the over-the-counter market likely con-

133 *See supra* text accompanying notes 42-48.

134 *See e.g.* Reference re Agricultural Products Marketing Act, 19 N.R. 361 (S.C.C. 1978).

135 *See supra* text accompanying notes 79-82.

135a Where the issuer is not incorporated the intraprovincial trading would occur in the province in which the securities are created, presumably the one in which the issuer resides.

136 A province may, of course, wish to delegate the administration of its securities act to a federal body, at least for intraprovincial transactions in an interprovincial distribution; *see infra* ch. III.I. It need hardly be said that all transactions in securities distributed by a foreign issuer would be within Parliament's jurisdiction

sists of intraprovincial transactions and would thus be beyond the coverage of the legislation. And it is at best doubtful whether even interprovincial trading by a securities firm would provide a sufficient foundation for a federal licensing requirement.[137] As a result, if Parliament were to rely on interprovincial and international trade for the regulation of distributions, it would be necessary to use another jurisdictional basis for the remainder of the scheme – that is, regulation of the trading market, the self-regulatory organizations and other securities market actors. That basis may be found in Parliament's authority over undertakings extending beyond a province and over works declared to be for the general advantage of Canada.[138] Interprovincial trade, in conjunction with these heads of power, may provide an adequate foundation for federal legislation.[139]

2. *General Trade and Commerce*

It may be possible, however, to rely exclusively on Parliament's jurisdiction over trade and commerce to justify a comprehensive federal regulatory scheme. Although the Privy Council in the *Parsons* case merely attempted to indicate generally the types of matters which might be of sufficient national concern to justify federal regulation of trade,[140] subsequent treatment of the dictum resulted in the ossification of the two strands contained in it into two distinct categories, "interprovincial and international trade and commerce" and "general trade and commerce", the former, as is indicated above, limited to transactions involving the shipment of commodities across a provincial border and the latter connoting trade or commerce affecting the nation as a whole in a nontransactional manner sufficient to warrant federal regulation.[141]

During the period of eclipse of the federal trade and commerce power both categories fell into disuse.[142] Indeed, even though one of the few cases in which Parliament's jurisdiction over general trade and commerce constituted part of the holding was decided during this period,[143] that decision became the vehicle for

137 *Cf.* A.G. Can. v. A.G. Alta., [1916] 1 A.C. 588 (P.C.); Canadian Indemnity Co. v. A.G.B.C., 73 D.L.R. (3d) 111 (S.C.C. 1976).

138 *See* BNA Act, s. 92(10).

139 Federal jurisdiction over works and undertakings is discussed *infra* ch. III.C.

140 *See supra* text accompanying notes 111–13. Even the wording of the dictum itself, quoted *supra* text accompanying note 113, makes this fact clear.

141 *See e.g.* A. Smith, *supra* note 109, chs. 3, 4; P. Hogg, *supra* note 32, ch. 15.

142 *See supra* notes 114–17 and accompanying text.

143 *See* John Deere Plow Co. Ltd. v. Wharton, [1915] A.C. 330, 340 (P.C. 1914) (once Parliament can create companies under residual power, "it becomes a question of general interest throughout the Dominion in what fashion they should be permit-

the strongest statement of limitation of federal powers;[144] and the Privy Council held invalid federal legislation directed at economic activities with clear national implications such as insurance,[145] combines, prices and profits,[146] labour relations and standards[147] and unemployment insurance.[148] Thus, despite the fact that the Privy Council softened its position[149] by upholding as a matter of general trade and commerce federal legislation creating a "national" trade mark,[150] it is not surprising that the concept was largely ignored.[151]

Recently, however, the Supreme Court of Canada resurrected the notion of general trade and commerce in a long dictum apparently intended to breathe new life into it and thus provide scope for Parliament to regulate economic matters of national concern. The case, *MacDonald v. Vapour Canada Ltd.*,[152] concerned a provision of the Trade Marks Act[153] that prohibited acts and business practices "contrary to honest industrial or commercial usage in Canada"[154] but that was unrelated to trade marks. Because the act created civil remedies in damages or injunctive relief for its breach,[155] the Chief Justice, writing for the majority, characterized the section as an attempt to create a civil cause of action

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ted to trade"). This use of the commerce power has been criticized; *see e.g.* P. Hogg, *supra* note 32, at 273 n. 40.

144 *See supra* cases cited in note 115.

145 *See e.g.* A.G. Can. v. A.G. Alta., [1916] 1 A.C. 588 (P.C.). This position has not been revised; *see* Canadian Indemnity Co. v. A.G.B.C., 73 D.L.R. (3d) 111, 116-18 (S.C.C. 1976).

146 *See In re* Board of Commerce Act, 1919, [1922] 1 A.C. 191 (P.C.). Legislation dealing with combines was subsequently sustained as criminal law under BNA Act, s. 91(27); *see* Proprietary Trade Articles Assn. v. A.G. Can., [1931] A.C. 310 (P.C.); and prices, profits and wages may be federally regulated in a time of emergency; *see* Reference re Anti-Inflation Act, [1976] 2 S.C.R. 373.

147 *See* Toronto Electric Commnrs. v. Snider, [1925] A.C. 396 (P.C.); *see also* A.G. Can. v. A.G. Ont., [1937] A.C. 326 (P.C.). Federal labour laws applicable to industries within federal legislative competence have been upheld; *see* Reference re Validity of Industrial Relations and Disputes Investigation Act, [1955] S.C.R. 529; and *see generally* P. Hogg, *supra* note 32, at 304-08.

148 *See* A.G. Can. v. A.G. Ont., [1937] A.C. 355 (P.C.).

149 *Cf. supra* note 118 and accompanying text.

150 *See* A.G. Ont. v. A.G. Can., [1937] A.C. 405, 417-18 (P.C.); *see also* R. v. Dominion Stores Ltd., 79 D.L.R. (3d) 627 (Ont. H.C. 1977), *affirmed*, 83 D.L.R. (3d) 266 (Ont. C.A. 1978).

151 Although it was not applied in any decisions, its theoretical existence continued to receive perfunctory recognition; *see e.g.* Reference re Farm Products Marketing Act, [1957] S.C.R. 198, 209, 228. And *see* Reference re Alberta Statutes, [1938] S.C.R. 100, 117-22 (*per* Duff, C.J.) (legislation altering the credit system beyond provincial jurisdiction as within s. 91(2) even though operates only within provincial boundaries).

152 66 D.L.R. (3d) 1 (S.C.C. 1976); *see also* Hogg, Comment, 54 Can. B. Rev. 361 (1976).

153 R.S.C. 1970, c. T-10.

154 *Id.* s. 7(e).

155 *Id.* s. 53.

unrelated to the rest of the act that was essentially the same as common and civil law remedies available in tort and delict and thus constituted an impermissible attempt by Parliament to "overlay or extend known civil causes of action" which were within provincial jurisdiction.[156] The Federal Court of Appeal had upheld the section under the general trade and commerce rubric as "a law laying down a set of general rules as to the conduct of businessmen in their competitive activities in Canada";[157] Chief Justice Laskin, therefore, was careful in declaring it invalid to point out that it "is not a sufficient peg on which to support the legislation that it applies throughout Canada when there is nothing more to give it validity".[158]

In concluding that the provision under consideration could not be supported under subsection 91(2), the Chief Justice briefly outlined the judicial interpretation of Parliament's general power to regulate trade[159] and suggested a number of factors relevant to a determination of its applicability to particular legislative initiatives. The majority opinion is implicitly premised on an acceptance of the thrust of the *Parsons* dictum,[160] that legislation within subsection 91(2) must be "concerned with trade as a whole"[161] or at least deal with a matter of general concern to the country.[162] The requisite generality may be indicated by the interprovincial nature of an enactment, that is, by a traditional transactional analysis,[163] or by its "transprovincial scope".[164] While it might ordinarily be unwise to attempt to determine the import of a decision from the use of a single term, it is less so when the opinion concerns constitutional law and is written by Chief Justice

156 66 D.L.R. (3d) at 11-19, 25.

157 Vapour Canada Ltd. v. MacDonald, 33 D.L.R. (3d) 434, 449 (Fed. C.A. 1972); *see also id.* at 444. (The difference in the spelling of the corporation's name reflects the styles of cause in the law reports at the various levels.) *Cf.* A.G. Ont. v. A.G. Can., [1937] A.C. 405, 417 (P.C.) ("There could hardly be a more appropriate form of the exercise of this power than the creation and regulation of a uniform law of trademarks").

158 66 D.L.R. (3d) at 19; *see also id.* at 21, 25-26.

159 *Id.* at 22-24.

160 *See supra* note 113 and accompanying text.

161 66 D.L.R. (3d) at 25.

162 *See id.* at 12, 20-27.

163 *See id.* at 12, 24. It is rather surprising in light of the diverse treatment of the two aspects of the trade and commerce head of power that the Chief Justice incorporates the interprovincial element into his analysis, even while distinguishing the marketing decisions; *see supra* text accompanying note 141. The fact that he does so may suggest an attempt to return to the integrated approach in the *Parsons* decision; *see supra* text accompanying notes 111-13, 140; *see also* P. Hogg, *supra* note 32, at 274 n. 59.

164 66 D.L.R. (3d) at 12.

Laskin[165] and when the word is one with obvious implications for the interpretation of the section which has not previously been used in any judicial decision interpreting it. The new term indicates that Parliament may legislate under the authority in subsection 91(2) in relation to matters that, although not involving interprovincial transactions, are of greater than provincial concern and seems intended to provide a broader basis for identification of such matters.[166] Its potential breadth is supported by a reference to credit legislation which is within the federal commerce power[167] if it involves "a public regulation thereof applicable to the conduct of trading and commercial activities throughout Canada".[168]

Indeed public regulation may help to support the generality of a regulatory scheme. The fact that paragraph 7(e) of the Trade Marks Act was enforceable exclusively in private actions was instrumental in defeating the argument in support of the legislation, in that it gave the provision a "local cast because it is as applicable in its terms to local or intraprovincial competitors as it is to competitors in interprovincial trade".[169] The Chief Justice stressed that the structure of a legislative scheme may in this manner influence its characterization and repeatedly indicated that the result would have been influenced had there been a regulatory scheme for the provision's enforcement administered by a government agency.[170] An administrative agency with a mandate to ensure the even-handed application of a scheme would at least provide evidence of Parliament's belief that the application of a national policy to a national problem is required and thus give some support to its "generality".[171] And if the legislation is valid on this basis, it may justify as well a civil remedy.[172]

Nevertheless, it is clear that the creation of a public authority will not alone support a scheme directed at intraprovincial trans-

165 The Chief Justice's profound knowledge of this subject is well known. His long attention to it is less so; *see e.g.* Laskin, *Taxation and Situs: Company Shares*, 19 Can. B. Rev. 617 (1941); B.L., Comment, 19 Can. B. Rev. 379 (1941); B.L., Comment, 19 Can. B. Rev. 750 (1941); Laskin, *A Note on Canadian Constitutional Interpretation*, 5 U. Toronto L.J. 171 (1943); B.L., Comment, 21 Can. B. Rev. 237 (1943); B.L., Comment, 21 Can. B. Rev. 597 (1943).

166 Nevertheless, the similarity of the concept to that expressed in *Parsons* is worth noting; *see supra* text accompanying note 113. *See also supra* cases cited in note 150.

167 *See* Laskin, *supra* note 35, at 347.

168 66 D.L.R. (3d) at 24, citing Duff, C.J.'s statements in Reference re Alberta Statutes, *supra* note 151.

169 66 D.L.R. (3d) at 26.

170 *Id.* at 12, 19-20, 25-27.

171 *See id.* at 25-26 ("would at least lend some colour to the alleged national or Canada-wide sweep"). *Cf.* Reference re Anti-Inflation Act, [1976] 2 S.C.R. 373, 422, 438.

172 66 D.L.R. (3d) at 21.

actions. This caveat is made manifest both in the significance attributed to the marketing decisions[173] and in the explanation of the holding of the Supreme Court thirty years earlier that Parliament lacked jurisdiction to establish a scheme requiring government "approval of agreements between persons engaged in a specific industry for controlling and regulating prices".[174] In fact the earlier Privy Council decisions holding invalid federal regulatory schemes administered by an administrative tribunal may be distinguished on the same basis;[175] all of them were directed at local transactions or agreements.[176]

In short, the apparent aim of the dicta in the majority opinion in *Vapour Canada* is to give some content to the concept of general trade and commerce. A regulatory scheme that is transprovincial in scope and administered by a public authority so that its enforcement is not dependent on redress of private grievances now appears to be within Parliament's jurisdiction to establish.[177] And the Supreme Court has indicated its willingness, where necessary, to overrule decisions of the Privy Council[178] as well as its own earlier decisions.[179]

Such extreme action should not be necessary to uphold federal legislation designed to regulate the Canadian securities market; indeed the dicta in the *Vapour Canada* decision provide, if anything, substantial support for a regulatory scheme like that outlined above.[180] A federal securities act would be directed not at a particular business or trade in the provinces but rather at the capital-raising function by issuers throughout Canada and would be designed to facilitate the allocational efficiency of the primary market, the capital-raising mechanism, by increasing investor

173 *Id.* at 24.

174 *Id.* at 77, citing Reference re Dominion Trade and Industry Commission Act, 1935, [1936] S.C.R. 379, 382; *cf. In re* the Board of Commerce Act, 1919, [1922] 1 A.C. 191 (P.C.).

175 *See e.g. supra* cases cited in notes 115-17; *see also* P. Hogg, *supra* note 32, at 274.

176 And Chief Justice Duff distinguished them on exactly this basis; *see* Reference re Alberta Statutes, [1938] S.C.R. 100, 119.

177 *Cf.* Reference re Anti-Inflation Act, [1976] 2 S.C.R. 373, 426-27 (*per* Laskin, C.J.). The Chief Justice in a dictum stated that the general trade and commerce concept provided Parliament with a "foothold" and that at least parts of the Act might have been upheld under s. 91(2). *But see id.* at 437 (authority to pass anti-inflation legislation does not stem "from any of the enumerated classes of subjects referred to in s. 91", dictum *per* Ritchie, J.).

178 *See e.g.* Reference re Agricultural Products Marketing Act, 19 N.R. 361, 367, 401-04, 423 (S.C.C. 1978) (overruling Lower Mainland Dairy Products Sales Adjustment Committee v. Crystal Dairy, Ltd., [1933] A.C. 168 (P.C. 1932)).

179 *See e.g.* Binus v. R., [1968] 1 C.C.C. 227, 229 (S.C.C.); McNamara Construction (Western) Ltd. v. R., 75 D.L.R. (3d) 273, 278-79 (S.C.C. 1977).

180 *See supra* ch. III.A.

confidence in the securities market generally.[181] Although this function necessarily involves transactions in securities, the aim of the legislation would be at distributions and issuers throughout Canada as a whole and not at specific transactions. Such legislation would clearly be "transprovincial in scope"[182] and the transactional element should not preclude its being characterized as a "general regulation of trade affecting the whole dominion".[183] This characterization would be reinforced by the fact that a regulatory authority of some sort would be required to administer and to enforce the provisions of the act.[184]

Parliament can therefore enact legislation requiring the filing and distribution of a prospectus containing specified information for all primary distributions of securities[185] and can require all issuers who distribute securities to continue to publicly disclose information relevant to investor decision-making on a regular and timely basis.[186] Continuing disclosure by issuers is also necessary for the secondary market to perform its role in providing support for the efficient functioning of the primary market.[187] To effectuate that role it may be advisable to extend the continuing disclosure requirements to all issuers the securities of which are actively traded.[188] Such a requirement would be directed at issuers rather

181 *See supra* ch. I.

182 66 D.L.R. (3d) at 12.

183 Citizens Insurance Company of Canada v. Parsons, 7 A.C. 96, 113 (P.C. 1881). It is clear, for example, that the Alberta credit legislation struck down by the Supreme Court in 1938 would have involved transactions in the province; *see* Reference re Alberta Statutes, [1938] S.C.R. 100, 122. And the federal anti-inflation legislation too applied to particular agreements; *see* Reference re Anti-Inflation Act, [1976] S.C.R. 373, 426 (dictum *per* Laskin, C.J.).

184 *See supra* text accompanying notes 169-71.

185 That the primary market involves matters of interprovincial concern is demonstrated by the percentage of new issues that are made in more than one province; approximately two thirds of the distributions of securities by industrial issuers in Canada from 1971 to 1974 were interprovincial. (In 1971, 74 of 112 distributions were interprovincial; in 1972, 100 of 150; in 1973, 79 of 133; and in 1974, 68 of 111. The figures for clearance of mutual funds for the same years are 67 of 114 in 1971, 66 of 120 in 1972, 71 of 154 in 1973 and 89 of 162 in 1974; over one half were interprovincial.) These figures are derived from tables of new issues prepared in the Corporate Research Branch, Consumer and Corporate Affairs Canada, for the years 1969 to 1974; the tables were based on the data concerning new issues contained in the weekly summaries published by the British Columbia, Québec and Ontario Commissions; the figures for 1971 and 1972, therefore, include only Québec and Ontario, while those for the succeeding two years include all three provinces. It is not clear how the figures would be altered if the other seven provinces were added.

186 *See supra* text accompanying note 93. This authority would also include supplementary disclosure, for example, by insiders and offerors; *see supra* text accompanying notes 94-96.

187 *See supra* text following note 2.

188 *See e.g. Grover & Baillie*, ch. VI.B (recommending continuing disclosure by issuers with over three hundred public holders of equity securities and discretion in a

than transactions or a business and would also come within the guidelines in *Vapour Canada* even if not tied to a prior distribution.[189]

As the trading market – that is, the stock exchanges and the over-the-counter market – consists of a large number of individual transactions most of which occur within a province, justification of federal legislation regulating its activities may at first appear more difficult. However, the economic function of the secondary market provides some support for such legislation in that it indicates the complementary nature of the trading and primary markets and thus the necessity for the former to function efficiently if the capital-raising mechanism is to do so.[189a] The transprovincial character of the Canadian secondary market is not demonstrated by economic theory alone but is also made manifest by the working of the Canadian stock exchanges on which, when compared with the over-the-counter market, the vast majority of secondary trading in equity securities occurs. The fact that each of the exchanges now provides reports of trades on the trading floors of the others, as well as those on its own,[189b] the joint mechanisms developed for clearing trades in securities and in put and call options and the current movement toward a computerized Canada-wide trading system,[189c] as well as the substantial number of interlisted securities and the procedures followed by the exchanges in obtaining approval for their by-laws and commission rates,[190] show conclusively that the secondary market as a whole transcends provincial authority and is a matter of national concern, that is, of general trade and commerce. This conclusion is bolstered by the related matter of continuing disclosure by issuers whose securities are actively traded.[191]

Parliament can therefore enact legislation to regulate the stock exchanges so long as it is directed at the regulation of the trading market rather than at individual transactions. A federal act might, for example, establish standards and procedures for supervision of the exchanges in the performance of their self-regulatory functions, possibly by imposing a registration require-

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commission to require filing by issuers with over that number of holders of other securities).

189 The criteria selected may, however, be relevant to the characterization; it is likely that the standards specified *id.* would be sufficient to indicate the transprovincial scope of the requirement. *Cf. e.g.* Ontario Securities Act, ss. 101(a), 118(1)(b) (issuers that have made a distribution or whose shares are listed on a stock exchange); Ontario Bill 7, s. 1(1)38 ("reporting issuer"); ALI Federal Securities Code, s. 402.

189a *See supra* text accompanying note 3.

189b *See infra* note 221 and accompanying text.

189c *See supra* text accompanying note 12 and following.

190 *See supra* text accompanying notes 9–11.

191 *See supra* text accompanying notes 186–89.

ment.[192] In this manner a federal regulatory body might supervise the establishment of the rules governing secondary trading, without having to deal directly with individual trades between investors.[193] The statute might also require all securities for which an active market exists to be listed on an exchange in order to facilitate the working of the secondary market and its supervision by the self-regulatory bodies[194] and might require or permit registration of other self-regulatory bodies exercising supervisory functions over the trading markets of interprovincial scope.[195] Such a scheme could readily be characterized as regulating commerce generally.

As the securities market underlies commercial activities throughout the country, the interprovincial or transprovincial impact of the primary and secondary markets is theoretically and practically clear. Federal legislation creating a scheme for their regulation to be administered by a public authority would come within the most recent explication by the Supreme Court of Canada of the general trade and commerce concept first espoused almost one hundred years ago to indicate Parliament's legislative jurisdiction. This characterization, if adopted, would likely be sufficient to justify a comprehensive system for regulation of all aspects of the market. However, several matters which may influence the characterization or which raise peculiarly difficult constitutional issues require further discussion.

In the *Vapour Canada* decision Chief Justice Laskin was careful to exclude from Parliament's jurisdiction matters of merely local significance even if carried out throughout Canada.[196] Although it is arguable that intraprovincial distributions of securities are an integral part of the primary market in Canada, it may be advisable to exclude them from the coverage of a federal act in order to emphasize its interprovincial thrust. Intraprovincial is-

192 *See e.g.* ALI Federal Securities Code, pt. VIII. The provincial securities acts require that an exchange be "recognized" before it may carry on business in the province, *see e.g.* Ontario Securities Act, s. 140(1). Another basis for federal jurisdiction over the secondary market is discussed *infra* ch. III.C.

193 *See supra* text accompanying note 169.

194 *See, Grover & Baillie*, text accompanying notes 313, 314. *Cf.* R. v. Klassen, 20 D.L.R. (2d) 406 (Man. C.A. 1969).

195 The most obvious example of such an organization is the Investment Dealers Association of Canada which supervises trading by its members in government bonds and money market instruments. The Investment Dealers Association should be treated like the exchanges in connection with its self-regulatory activities; however, the fact that the securities with which it is concerned are traded over-the-counter brings them closer to an intraprovincial characterization. As a result, a federal act could permit voluntary registration after which the organization would be subject to the specified standards; *see e.g.* R. v. Dominion Stores Ltd., 79 D.L.R. (3d) 627 (Ont. H.C. 1977), *affirmed*, 83 D.L.R. (3d) 266 (Ont. C.A. 1978).

196 *See supra* text accompanying notes 155-58, 169, 173-74.

sues are usually small offerings by local issuers seeking to obtain financing for a local venture in which federal interest is minimal;[197] and the regulatory policies governing them, which are frequently related to the exploitation of natural resources,[198] should be left to the provinces in any event.[199] In short, intraprovincial distributions provide a clear example of a problem in which substantive and constitutional considerations lead to the same result.

Secondary distributions and the over-the-counter market raise similar difficulties. A distribution by a person other than the issuer of the securities is unrelated to the raising of capital that provides a basis for the application of the general trade and commerce concept; and the over-the-counter market in Canada is small, at least in connection with equity securities, and appears to be essentially intraprovincial and unconnected with the national marketplace developing on the exchanges. Nevertheless, it is arguable that coverage of both is necessary to ensure the effective implementation of any legislation that is enacted.

At least some secondary distributions must be included in order to preclude evasion of the requirements applicable to a primary issue by means of a two-step distribution; such attempts would be treated as primary distributions in any event. True secondary sales, for example, by a controlling person, must also be covered if the legislation is to accomplish its purpose of instilling confidence in the market so that it operates as an efficient allocational mechanism. Investors must be in a position to select between securities on the basis of full information; the selling pressure that usually accompanies a distribution, without corresponding disclosure, might divert funds from enterprises seeking them and thus result in misallocation of resources.[200] As a result, a provision of a federal act applying the same requirements to

197 The intrastate exemption in the Securities Act of 1933, s. 3(a)(11), was intended to deal with similar distributions; *see e.g.* SEC, 1 Report of the Special Study of Securities Markets 570-71 (1963).

198 For example, of 93 prospectuses for junior mines filed in Ontario and Québec in 1971, only two were filed in both provinces and only five of the 89 prospectuses filed in 1972 were filed in both. In 1973 there were 128 prospectuses for mining companies filed in British Columbia, Ontario and Québec of which three were filed in more than one province and in 1974 only two of the 94 prospectuses filed were interprovincial. These figures are derived from the tables described *supra* in note 185.

199 For the experience in the United States with the intrastate exemption, *see e.g.* SEC, *supra* note 197, at 571-74; 1 L. Loss at 591-605; 4 L. Loss at 2600-06; ALI Federal Securities Code, Tent. Draft No. 3, s. 513 and s. 1603, Comment (16); and *see, Howard*, text accompanying notes 178-79.

200 All securities legislation applies equally to primary and secondary offerings; *see e.g.* Ontario Securities Act, s. 1(1)6a ("distribution").

secondary as to primary issues of securities would likely be upheld as necessary to the statutory scheme.[201]

A similar analysis would result in regulation of the over-the-counter market being held ancillary to that of the exchanges to ensure that the legislative scheme cannot be avoided, for example, by an issuer not obtaining a listing for its securities. The small volume of equity trading on the over-the-counter market when compared with that on the exchanges might serve to reinforce this position. In any event, it would be possible to accomplish the same result by making listing mandatory for all issuers with a class of securities held by a sufficient number of persons to create a public market in them.[202]

Perhaps the most difficult element of a securities law to justify federally is the licensing of brokers, dealers and other market actors and the concomitant establishment of standards of competence and integrity and capital requirements.[203] Any licensing scheme by the federal government directed at a specific business is especially dubious in light of the long line of insurance cases precluding Parliament from regulating "a particular trade in which Canadians would otherwise be free to engage in the provinces".[204] The authority of these decisions continues not only in respect of the insurance business[205] but also in respect of all trades conducted in the provinces, that is, in Canada.[206] As a result it is clear that Parliament could not enact a scheme requiring the licensing of securities firms even if they carry on business in several provinces.[207]

It is less than clear, however, whether Parliament could impose a licensing requirement on securities firms as part of a broader statute that is otherwise within its power. Indeed it is arguable that Parliament can impose such a requirement where it is necessarily incidental to a valid regulatory scheme,[208] and this type of

201 *See supra* notes 125, 126, 128.

202 *See supra* note 194 and accompanying text.

203 *See supra* text accompanying note 98. It might be argued that Parliament can impose capital requirements on securities firms under BNA Act, s. 91(21) in order to prevent insolvency; *cf.* Bankruptcy Act, 1978, Bill S-11, 30th Parl., 3d Sess., pt. VII (First reading March 21, 1978) (bankruptcy of securities firms). But the success of the argument is doubtful; *see* P. Hogg, *supra* note 32, at 302.

204 A.G. Can. v. A.G. Alta., [1916] 1 A.C. 588, 596 (P.C.); *see also* A.G. Ont. v. Reciprocal Insurers, [1924] A.C. 328 (P.C.); on the insurance cases generally, *see* P. Hogg, *supra* note 32, at 299-303.

205 *See* Canadian Indemnity Co. v. A.G.B.C., 73 D.L.R. (3d) 111 (S.C.C. 1976).

206 *See e.g.* R. v. Eastern Terminal Elevator Co., [1925] S.C.R. 434; and *see* P. Hogg, *supra* note 32, at 302-03.

207 *See e.g.* P. Hogg, *supra* note 32, at 300.

208 *See e.g.* A. Smith, *supra* note 109, at 127.

argument has been upheld in at least one recent decision.[209] Thus if a comprehensive scheme for the regulation of the Canadian market is valid as described above, it is possible that a licensing requirement would be upheld as necessary to ensure the integrity of the securities market,[210] as there can be little doubt that a "rational, functional connection" between the two exists.[211] Nevertheless, a licensing requirement of this nature might influence the characterization of the legislation itself.[212] As a federal agency would be able to establish standards of conduct for securities firms through its supervisory powers over the self-regulatory organizations of which they are members, it may be advisable not to impose a licensing requirement on securities firms in the statute or at least to draft the legislation so that the part dealing with the requirement is severable.[213]

In result, Parliament's jurisdiction over trade and commerce generally is alone sufficient to uphold federal legislation that comprehensively regulates all aspects of the market that are of more than provincial significance. Even if it were unavailable, Parliament has authority to regulate interprovincial distributions and other trading in the same manner as it does commodities and to deal with the secondary market and the self-regulatory organizations under a head of power in subsection 92(10); this alternative approach would also permit the enactment of a comprehensive scheme of regulation.[214]

C. WORKS AND UNDERTAKINGS

Although subsection 92(10) of the BNA Act gives the provincial legislatures jurisdiction over "local works and undertakings", its major effect lies in the exceptions from it.[215] The subsection excepts

> "(a) Lines of Steam or other Ships, Railways, Canals, Telegraphs, and other Works and Undertakings connecting the Province with any other or others of the

209 *See* Montana Mustard Seed Co. Inc. v. Continental Grain Co. (Canada) Ltd., 49 D.L.R. (3d) 72, 75-77 (Sask. C.A. 1974), *affirmed on other grounds*, [1976] 2 W.W.R. 768 (S.C.C. 1975).

210 *Cf. id.* at 76.

211 Papp v. Papp, 8 D.L.R. (3d) 389, 393-94 (Ont. C.A. 1969).

212 *See e.g.* LASKIN, *supra* note 35, at 98-100; P. HOGG, *supra* note 32, at 80-82.

213 Severability is discussed *infra* ch. III.G.

214 *See supra* text accompanying notes 138, 139.

215 In fact, it is likely that the subsection was included primarily in order to make clear that the matters excepted from it are within federal jurisdiction as is indicated by the fact that local works and undertakings come within BNA Act, ss. 92(13) and (16) in any event; *cf. e.g.* McNairn, *Transportation, Communication and the Constitution: The Scope of Federal Jurisdiction*, 47 CAN. B. REV. 355, 356 (1969).

> Provinces, or extending beyond the Limits of the Province...[and]
> "(c) Such Works as, although wholly situate within the Province, are before or after their Execution declared by the Parliament of Canada to be for the general Advantage of Canada or for the Advantage of Two or more of the Provinces."

And the exceptions are, rather redundantly, expressly included in subsection 91(29) as federal heads of power.[216]

A Canada-wide automated trading system which replaces the trading floors of the stock exchanges and permits execution and clearing of trades in securities by means of computers located throughout the country will constitute an interprovincial undertaking within federal jurisdiction under paragraph 92(10)(a).[217] Although the purpose of such a system is trading in securities, the means used to accomplish it necessarily involve a communications network extending beyond a single province[218] and are analogous to an interprovincial telephone system which has been held to come within the exception.[219] Thus the development of a national automated trading system will, like the telephone, augment federal regulatory power.

Parliament's jurisdiction under this head of power is, however, not contingent upon the development of an automated trading system that replaces the existing exchange floors; the manner in which the exchanges now carry on business and the connections necessary to facilitate it may alone be sufficient to make their undertakings interprovincial. In fact of the three elements essential to an exchange, namely, trading, clearing and the quotation of securities prices, the latter two are handled in Canada on an interprovincial basis. As was mentioned above, the clearing and settlement of securities traded on the Montreal and Toronto Exchanges are handled by the Canadian Depository for Securities by means of a computerized facility and the same functions are performed for the Alberta and Vancouver Exchanges by the Vancouver Stock Exchange Service Corporation.[220] More important, perhaps, is the fact that the Montreal, Toronto and Vancouver Exchanges have installed automated systems so that the details of transactions on any of the three exchanges are available

216 *See e.g.* Toronto v. Bell Telephone Co. of Canada, [1905] A.C. 52, 57 (P.C. 1904); Commission du salaire minimum v. Bell Telephone Co. of Canada, [1966] S.C.R. 767, 771.

217 The movement toward such a system is described *supra* text following note 12; *see also, Cleland; Jenkins; Williamson, Financial Institutions*, ch. IV.B, C.

218 *See e.g.* Canadian Pacific Railway Co. v. A.G.B.C., [1950] A.C. 122, 142 (P.C. 1949).

219 *See supra* cases cited in note 216.

220 *See supra* note 217.

simultaneously on all three floors. In other words the three exchanges have, in effect, a common quotation system linked by computer or telephone lines that extend beyond the limits of the provinces in which they are located.[221]

The question that presents itself is whether these elements are sufficient to bring the exchanges within the initial exception in subsection 92(10) as interprovincial undertakings. Even if, as has been suggested, the exception is limited to works and undertakings involving transportation or communications,[222] the clearing and quotation systems qualify; both involve the transmission of information and both are integral to the functioning of the exchanges.[223] The relationship of the clearing function to trading

221 The quotation systems of the three exchanges are, however, independently operated. The Toronto Stock Exchange has developed the CANDAT II system which contains information on transactions occurring on the floors of all three exchanges as well as for Canadian and other securities on several American exchanges and on NASDAQ, *see, Cleland,* ch. VI.B.7, and CANDAT II terminals are maintained on the trading floors of the Vancouver and Montreal Exchanges. The CANDAT II system is clearly an interprovincial undertaking operated by the Toronto Stock Exchange which may alone be sufficient to bring that Exchange within federal jurisdiction.

Both the Montreal and Vancouver exchanges also participate in CANDAT II to the extent that they supply information concerning trading on their floors and obtain royalties for its use by lessees of the system; but it is questionable whether such participation is alone sufficient to bring them within federal jurisdiction on the same basis as the Toronto Exchange which owns, manages and operates the system. Both exchanges, however, disseminate information on their trading by other means as well, for example, by supplying trading information to the Combined Market Quotations system, which provides data on trading in interlisted securities on the Montreal, Toronto, Vancouver and New York exchanges, again on a royalty basis. The Vancouver Stock Exchange transmits the information by means of a computerized "Market and Reference Service" (MARS), *see, Cleland,* app. B, and the Montreal Stock Exchange too does so by means of its computer. Moreover, the Montreal Exchange has recently permitted the Canadian Press to establish a direct connection with its computer for purposes of disseminating trading information on its ticker, yet again on a royalty basis. Finally, the Montreal Exchange has on its floor a number of screens which show the trading information transmitted on the ticker from the Toronto, New York and American Stock Exchanges.

While these arrangements, other than the CANDAT II system, may if viewed severally be treated as local undertakings, when taken together they in effect provide an integrated mechanism for the transmission of trading information between the floors of the three exchanges.

222 *See e.g.* P. HOGG, *supra* note 32, at 324. On occasion, however, it is necessary to stretch the cases in order to bring within these two categories all of the works and undertakings held to be within the exception; *see* McNairn, *supra* note 215, at 359-60 ("energy" is "transported" through electrical wires).

223 *Cf. e.g.* Commission du salaire minimum v. Bell Telephone Co. of Canada, [1966] S.C.R. 767, 772 (matters which are "a vital part" of interprovincial undertaking within federal jurisdiction). Although the criterion enunciated by the Supreme Court relates to jurisdiction over elements associated with an undertaking that has already been determined to be interprovincial, similar considerations are relevant to the determination of whether the interprovincial elements of an undertaking are sufficiently related to its operation to make the whole undertaking interprovincial; *see e.g.* Canadian Pacific Railway Co. v. A.G.B.C., [1950] A.C. 122, 142-45

is obvious; it involves the matching of the number of securities purchased and sold so that the members of the exchanges may conclude their transactions. The quotation system also facilitates trading not only by enabling arbitrage transactions between the different exchanges so that a national price may be reflected for an interlisted security[224] but also by enabling brokers to find the best price possible for their client.[225] The importance of the integrated quotation systems is emphasized by the fact that over one half of the securities listed on the Toronto Stock Exchange are listed on one of the other Canadian exchanges as well.[226]

While it might be argued that the major function of the exchanges is trading which is for the most part intraprovincial, it is undeniable that the clearing and quotation systems are integral parts of the exchanges' undertakings and are essential supports for the trading conducted on their floors. As a result, the undertakings as a whole extend beyond the provinces in which the exchanges are located and come within paragraph 92(10)(a).[227] Nevertheless, the courts are likely to be reluctant to accept this conclusion so long as no federal legislation regulating the exchanges has been enacted,[228] as once a matter falls within an

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(P.C. 1949) (holding Empress Hotel a separate business and not a part of appellant's railway undertaking); *see also* Re Public Service Bd., 83 D.L.R. (3d) 178, 181 (S.C.C. 1977) ("The fundamental question is...what the service consists of...the inquiry must be as to the service that is provided and not simply as to the means through which it is carried on. Divided constitutional control of what is functionally an interrelated system...not only invites confusion but is alien to the principle of exclusiveness of legislative authority").

224 *See supra* text accompanying notes 21-26. *Cf.* G. WYSER-PRATTE, RISK ARBITRAGE 7-9 (1971); and *see e.g.* MSE General Rules, ss. 6351-56, 3 CCH CAN. SEC. L. REP. ¶¶ 86-209 - 86-214.

225 *See e.g.* Notice re: Buy and Sell Orders of Securities Originating in British Columbia, B.C. Corporate and Financial Services Division Weekly Summary, September 12, 1978, at 8 (broker's duty to obtain best execution for client). This duty emphasizes as well the transprovincial nature of the securities market.

226 *See, Cleland.* Moreover, approximately 80 of the securities listed on the Toronto Stock Exchange are listed on an American exchange or are included in the NASDAQ system and a number of American issuers have listings on the Toronto Stock Exchange.

227 *See e.g.* A.G. Ont. v. Winner, [1954] A.C. 541 (P.C.); Capital Cities Communications Inc. v. CRTC, 81 D.L.R. (3d) 609, 621-23 (S.C.C. 1977); *see also* McNairn, *supra* note 215, at 374. Nor does the fact that the majority of trading in Canada (approximately 70%) occurs through the Toronto Stock Exchange detract from this conclusion. Indeed the courts have held that a substantially smaller percentage than 30% is sufficient to constitute an undertaking interprovincial; *see* P. HOGG, *supra* note 32, at 326-27. Thus even if the percentage of interlisted trading is only a small proportion of the total trading, it is likely to be sufficient. And *see id.* at 329.

228 *See supra* note 41 and accompanying text. *Cf.* McNairn, *supra* note 215, at 386 (never suggested that facilities for interprovincial telephone calls provided by intraprovincial systems "enough to bring these systems under federal control").

exception to subsection 92(10) it is no longer subject to provincial regulation.[229]

Parliament may also obtain jurisdiction over the exchanges through the exercise of the power conferred by paragraph 92(10)(c) to declare a work "to be for the general advantage of Canada".[230] Such a declaration would preclude provincial regulation of the exchanges and would make them subject to exclusive federal jurisdiction.[231] In fact, after the Supreme Court's decision in the *Eastern Terminal Elevator* case holding the regulation of the grain trade by means of a licensing system directed at grain elevators and warehouses to be beyond Parliament's jurisdiction,[232] Parliament enacted a new statute to accomplish the same purpose which included a declaration that all grain elevators and warehouses were works for the general advantage of Canada.[233] And the declaration has been upheld as a sufficient basis for comprehensive regulation of the delivery, receipt, storage and processing of grain.[234] In short, a parliamentary declaration confers full regulatory power not only over the work itself but also over the activities carried on in it.[235]

As the stock exchanges consist of trading floors and other physical facilities, it is clear that they are "works"[236] and a parliamentary judgment that they are for Canada's general advantage is a matter of policy which will not be questioned by the

229 *See e.g.* A.G. Ont. v. Winner, [1954] A.C. 541, 579-80 (P.C.); Commission du salaire minimum v. Bell Telephone Co. of Canada, [1966] S.C.R. 767, 774; *but cf.* A.G. Que. v. Kellogg's Company of Canada, 19 N.R. 271 (S.C.C. 1978) (provincial legislation dealing with local trade may "affect" such undertakings).

230 *See supra* text accompanying note 216.

231 *See id.*; Madden v. Nelson and Fort Sheppard Ry. Co., [1899] A.C. 626, 628 (P.C.). For a general discussion of this exception, *see* A. Lajoie, Le Pouvoir Déclaratoire du Parlement (1969); P. Hogg, *supra* note 32, at 329-32; Laskin, *supra* note 35, at 478-82.

The declaratory power has been used at least 470 times, most frequently in relation to local railways but also for a variety of other types of works such as canals, bridges, dams, tunnels, harbours, wharves, telegraphs, telephones, mines, mills, hotels, restaurants, theatres, oil refineries, factories and grain elevators; *see* A. Lajoie, *supra* at 54, 123-51; P. Hogg, *supra* at 330.

232 *See* R. v. Eastern Terminal Elevator Co., [1925] S.C.R. 434; *see also supra* text accompanying note 117.

233 *See* Canada Grain Act, S.C. 1925, c. 33, s. 234; the history of the provision is outlined in Jorgenson v. A.G. Can., [1971] S.C.R. 725, 730.

234 *See* Jorgenson v. A.G. Can., [1971] S.C.R. 725.

235 *See id.*; Chamney v. R., [1975] 2 S.C.R. 151 (1973); *see also* Montana Mustard Seed Co. Inc. v. Continental Grain Co. (Canada) Ltd., 49 D.L.R. (3d) 72 (Sask. C.A. 1974), *affirmed*, [1976] 2 W.W.R. 768 (S.C.C. 1975).

236 *See e.g.* Montréal v. Montreal Street Ry., [1912] A.C. 333, 342 (P.C. 1911) ("works are physical things, not services"); *see also* Jorgenson v. A.G. Can., [1971] S.C.R. at 729 (court must be satisfied declaration refers to a "work"). A national computerized trading system would necessarily also be housed in a "work".

courts.[237] In the present political climate, however, it is doubtful that Parliament would exercise its declaratory power without prior negotiations with and presumably agreement by the provinces.[238]

Parliament has, therefore, jurisdiction under both of the quoted exceptions from subsection 92(10)[239] to enact legislation regulating the securities exchanges and any trading conducted through their facilities. Indeed, as its jurisdiction would be plenary,[240] Parliament might require all transactions in securities to be made through an exchange in order to regulate the trading markets effectively.[241] It could also set standards for and supervise the exchanges' self-regulatory activities,[242] establish continuing disclosure requirements for issuers whose securities are traded on an exchange (effectively all issuers whose securities are publicly traded),[243] and even over brokers and dealers who might be required to become exchange members.[244] In this manner Parliament's jurisdiction under subsections 92(10) and 91(29) may complement its powers to regulate interprovincial trade so that the two heads of power may be used as the basis for a comprehensive scheme for regulation of the Canadian securities market.[245]

However, as the outcome of constitutional adjudication cannot be predicted with certainty, a number of other bases of federal jurisdiction which may serve to support such legislation are considered as well.

237 *See e.g.* P. Hogg, *supra* note 32, at 331; A. Lajoie, *supra* note 231, at 69-70; Laskin, *supra* note 35, at 479.

238 *See e.g.* P. Trudeau, A Time for Action: Toward the Renewal of the Canadian Federation 11, 15-17 (1978); McNairn, *supra* note 215, at 392 ("declaratory power cannot now be practically exploited by the Dominion to any great extent"); P. Hogg, *supra* note 32, at 331-32 (Parliament "now inclined to use the power only sparingly").

239 *See supra* text following note 215.

240 *See supra* notes 216, 231.

241 *See supra* text following note 201 and accompanying notes.

242 *See also supra* text accompanying notes 188-95. Other self-regulatory bodies might be treated similarly if it is necessary to do so in order to achieve an effective regulatory scheme.

243 *See also supra* text accompanying notes 186-89.

244 *See supra* text accompanying notes 203-13. As jurisdiction over members would effectively permit the establishment of standards for brokers and dealers, it is arguable that a licensing scheme to regulate such persons, rather than indicating an attempt to regulate business activities in a province, is merely an alternative technique of accomplishing a result that is necessary to the integrity of the regulatory scheme; *see e.g.* Montana Mustard Seed Co. Inc. v. Continental Grain Co. (Canada) Ltd., *supra* note 235.

245 *See supra* text accompanying notes 137-39 and text following note 213.

D. THE PEACE, ORDER AND GOOD GOVERNMENT OF CANADA

Although Parliament's legislative jurisdiction over trade and commerce and over works and undertakings provides a sufficient basis for a federal securities law, its general power "to make Laws for the Peace, Order, and good Government of Canada, in relation to all Matters not coming within the Classes of Subjects...assigned exclusively to the Legislatures of the Provinces"[246] may also serve to support such legislation and must, therefore, be considered. The scope of this general power has been defined in judicial decisions and, like "general trade and commerce", its parameters are still unclear.[247]

In fact the judicial approach to the two powers has tended until recently to develop along parallel lines. The Privy Council initially adopted a broad interpretation of the peace, order and good government clause, holding that a desire to deal uniformly with a nationwide problem on a nationwide basis was sufficient to take a matter beyond the class of subjects "assigned exclusively to the Legislatures of the provinces" in section 92.[248] Again,[249] during the succeeding half century the Privy Council consistently restricted the potential scope of Parliament's general power until by 1926 it was limited to situations in which a national emergency existed which was incapable of being adequately dealt with by the

246 BNA Act, s. 91.

247 *See supra* text following note 139.

248 *See* Russell v. R., 7 A.C. 829, 841-42 (P.C. 1882); *cf.* Citizens Insurance Co. of Canada v. Parsons, 7 A.C. 96 (P.C. 1881), discussed *supra* text accompanying notes 110-13. Both decisions were written by Sir Montague Smith and it is worth noting that in *Russell* he indicated that the legislation under consideration, the Canada Temperance Act, 1878, would likely have been justifiable as well under s. 91(2) of the BNA Act as a "general regulation of the traffic in intoxicating liquors throughout the Dominion"; 7 A.C. at 842. It is now clear that a desire for uniform legislation governing an activity carried on throughout Canada is not alone sufficient to bring a matter within either the general power or s. 91(2); *see e.g.* Reference re Anti-Inflation Act, [1976] 2 S.C.R. 373, 400 ("mere desire for uniformity cannot be a support for an exercise of the federal general power" *per* Laskin, C.J.); *cf.* MacDonald v. Vapour Canada Ltd., 66 D.L.R. (3d) 1, 19 (S.C.C. 1976), quoted *supra* text accompanying note 158. For a more restrictive reading of *Russell*, *see* Gibson, *Measuring "National Dimensions"*, 7 MAN. L.J. 15, 18-20 (1976); *see also* Reference re Anti-Inflation Act, *supra* at 396-98, 400 (*per* Laskin, C.J.: *Russell* not founded on uniformity alone).

249 *See supra* text accompanying notes 114-19. The process of truncation beginning with A.G. Ont. v. A.G. Can., [1896] A.C. 348 (P.C. 1895), and the subsequent "expansive" interpretations are described more fully elsewhere; *see e.g.* Laskin, "*Peace, Order and Good Government*" *Re-examined*, 25 CAN. B. REV. 1054, 1067-83 (1947); P. HOGG, *supra* note 32, ch. 14; W. MCCONNELL, *supra* note 114, at 137-59; and *see* Reference re Anti-Inflation Act, [1976] 2 S.C.R. at 396-417 (*per* Laskin, C.J.).

provinces[250] and to cases which by necessary inference from the words of section 92 were not within provincial powers.[251] It is not surprising that the limitations on trade and commerce and "peace, order, and good government" were developed in tandem during this period for both were the obvious bases upon which to attempt to justify a broad range of federal economic regulation including the licensing of insurance companies[252] and the control of profiteering[253] and labour unrest.[254]

Although a few decisions during the succeeding decade indicated a potential scope for the general power beyond emergencies and beyond mere literary exegesis,[255] the rationale enunciated in them was almost immediately undermined[256] and the continued application of the Privy Council's earlier decisions in a series of cases holding, in effect, that the depression did not constitute an emergency sufficient to justify the Bennett "new deal" legislation reinforced the restrictive interpretation of Parliament's general power.[257] Even a direct assault by the Privy Council itself was

250 *See* Toronto Electric Commnrs. v. Snider, [1925] A.C. 396, 410-16 (P.C.); *In re* Board of Commerce Act, 1919, [1922] 1 A.C. 191, 197-98, 200 (P.C. 1921). The two "great wars" and their aftermaths have been held to be "emergencies" meeting the necessary prerequisites; *see e.g.* Fort Frances Pulp and Power Co., Ltd. v. Manitoba Free Press Co., Ltd., [1923] A.C. 695 (P.C.) (wartime price controls); Co-operative Committee on Japanese Canadians v. A.G. Can., [1947] A.C. 87 (P.C. 1946) (deportation of Japanese Canadians after war); Reference re Wartime Leasehold Regulations, [1950] S.C.R. 124 (rents).

251 *See e.g.* John Deere Plow Co., Ltd. v. Wharton, [1915] A.C. 330, 339-40 (P.C. 1914). This approach to the interpretation of federal powers has been called the "gap theory"; *see* Abel, *The Anti-Inflation Judgment: Right Answer to the Wrong Question?* 26 U. Toronto L.J. 409, 439 (1976); P. Hogg, *supra* note 32, at 245-46. It has been suggested that all of the decisions in this period reflect a contemporary social orientation in favour of business activities; *see e.g.* Abel, *supra* at 441 n. 186.

252 *See* A.G. Can. v. A.G. Alta., [1916] 1 A.C. 588, 596-97 (P.C.) (insurance business).

253 *See In re* Board of Commerce Act, 1919, *supra* note 250.

254 *See* Toronto Electric Commnrs. v. Snider, *supra* note 250; *see also* A.G. Can. v. A.G. Ont., [1937] A.C. 326 (P.C.).

255 *See In re* Regulation and Control of Aeronautics, [1932] A.C. 54, 77 (P.C. 1931) (dictum); *In re* Regulation and Control of Radio Communication, [1932] A.C. 304, 312 (P.C.). The dictum in the former case and the holding in the latter were to the effect that matters involving international agreements were within Parliament's general legislative jurisdiction as s. 132 of the BNA Act was no longer applicable and such matters had not otherwise been expressly provided for; the cases seemed to indicate, therefore, that the general power encompassed subject matters not expressly included in ss. 91 and 92. *But see infra* note 256 and accompanying text. *Cf. supra* text accompanying notes 118, 119.

256 *See* A.G. Can. v. A.G. Ont., [1937] A.C. 326, 350-51 (P.C.) (*Aeronautics* case decided under s. 132 and *Radio* case held radio necessarily involved undertakings like telegraphs within paragraph 92(10)(a)).

257 *See e.g.* A.G. Can. v. A.G. Ont., [1937] A.C. 355 (P.C.) (unemployment insurance); A.G.B.C. v. A.G. Can., [1937] A.C. 377 (P.C.) (natural products marketing); *see also* Canadian Federation of Agriculture v. A.G. Que., [1951] A.C. 179, 197-98 (P.C. 1950); on the "new deal" generally, *see e.g.* P. Hogg, *supra* note 32, at 250 n. 54;

unable to dislodge the so-called emergency doctrine as the primary basis for the application of the general power of Parliament. In the *Canada Temperance Federation* case Viscount Simon, attempting to reconcile all of the Privy Council's decisions on the meaning of "the peace, order, and good government of Canada", enunciated the "true test" for determining the validity of legislation under the provision;[258] a matter that "must from its inherent nature be of concern to the Dominion as a whole" and, therefore, exceeds "local or provincial concern or interests" falls within Parliament's general power even though it might from another aspect also be within provincial legislative competence.[259] The "national concern test" thus enabled the Privy Council to uphold the continued vitality of the *Russell* decision[260] and to treat a national emergency as only one example of the type of circumstances that might take a matter beyond provincial concern; in fact the Judicial Committee equated the emergency cases with the fields of aeronautics and radio as being merely different applications of the same approach.[261] Even though the seemingly new test did no more than restate Lord Watson's earlier description of the function of the general power,[262] the Privy Council chose to ignore it and to apply the emergency doctrine in a case decided later in the same year[263] and subsequently appeared to disaffirm it.[264] However, as all of the decisions stood and as none were expressly overruled, the "correct" approach to the interpretation of the general power was in 1951 far from certain.[265]

Laskin, *supra* note 249, at 1080 (Privy Council's decisions "surely a monument to judicial rigidity").

258 A.G. Ont. v. Canada Temperance Federation, [1946] A.C. 193, 205 (P.C.).

259 *Id.*

260 *Id.* at 204-08. In declaring, accurately, that *Russell* had not been decided on the basis of an emergency, the Privy Council expressly disaffirmed Viscount Haldane's explanation of the case, *id.* at 206, thus implicitly accepting Chief Justice Anglin's earlier indignant repudiation; *see* R. v. Eastern Terminal Elevator Co., [1925] S.C.R. 434, 438.

261 [1946] A.C. at 205-06.

262 *See* A.G. Ont. v. A.G. Can., [1896] A.C. 348, 360-61 (P.C.) ("some matters, in their origin local and provincial, might attain such dimensions as to affect the body politic of the Dominion...and...become matter[s] of national concern").

263 *See* Co-operative Committee on Japanese Canadians v. A.G. Can., [1947] A.C. 87 (P.C. 1946).

264 *See* Canadian Federation of Agriculture v. A.G. Que., [1951] A.C. 179, 197-98 (P.C. 1950); *but see* Reference re Anti-Inflation Act, [1976] 2 S.C.R. 373, 417 (*per* Laskin, C.J.).

265 The uncertainty was heightened by the fact that the Privy Council in 1949, while rejecting an argument based upon the general power, adopted Lord Watson's statement of its role; *see* C.P.R. v. A.G.B.C., [1950] A.C. 122, 138-41 (P.C. 1949); *see also* Laskin, *supra* note 249, at 1083; W. McConnell, *supra* note 114, at 153. *Cf.* Reference re Anti-Inflation Act, [1976] 2 S.C.R. 373, 396 (*per* Laskin, C.J.) (reconciling *Canada Temperance Federation* and *Japanese Canadians* cases on basis that

After the abolition of appeals to the Privy Council the Supreme Court of Canada adopted and consistently applied the "national concern" test enunciated by Viscount Simon to uphold federal jurisdiction over aeronautics[266] and offshore mineral rights[267] as well as Parliament's authority to establish a national capital region[268] and a language policy for its agencies.[269] And the lower courts followed suit.[270] Recently, however, the Supreme Court altered the pattern that appeared to be developing and resurrected the emergency doctrine.[271] Despite the fact that the Anti-Inflation Act reflected in its preamble the recent Canadian decisions outlined above[272] and that the counsel for the federal government relied primarily on the "national concern" test, [273] the Supreme Court upheld the Act on one ground only, that inflation in Canada at the time of its enactment was reasonably apprehended by Parliament as an emergency.[274] And although the analysis of the Chief Justice in the plurality opinion indicated some sympathy for the national concern test in the *Canada Temperance Federation* case,[275] the majority of the Court, while differ-

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"particular legislation with which the Court had to deal and the circumstances in which that legislation came under scrutiny" were "the commanding considerations").

266 *See* Johannesson v. West St. Paul, [1952] 1 S.C.R. 292 (1951). Four of the five justices relied on the dictum in *Canada Temperance Federation* while Chief Justice Rinfret held that the issue was concluded by the *Aeronautics Reference*, *supra* note 255.

267 *See* Reference re Offshore Mineral Rights of B.C., [1967] S.C.R. 792.

268 *See* Munro v. National Capital Commn., [1966] S.C.R. 663.

269 *See* Jones v. A.G.N.B., [1975] 2 S.C.R. 182, 189 (1974).

270 *See* Pronto Uranium Mines Ltd. v. Ont. Labour Relations Bd., [1956] O.R. 862 (H.C.); Denison Mines Ltd. v. A.G. Can., [1973] 1 O.R. 797 (H.C. 1972) (atomic energy); Re C.F.R.B., [1973] 3 O.R. 819 (C.A.), *leave to appeal refused*, [1973] S.C.R. ix. *See also* P. Hogg, *supra* note 32, at 258 (every case since 1949, except *Anti-Inflation Reference*, decided by Canadian courts "on the basis of the Canada Temperance test"); *cf. supra* text accompanying notes 120-28.

271 *See* Reference re Anti-Inflation Act, [1976] 2 S.C.R. 373. As a result, the decision represents the first time that the general approach to the general power has differed substantially from that to the interpretation of "trade and commerce"; while the *Vapour Canada* decision indicates a continuation of the expansive approach to the latter head of power, *see supra* text accompanying notes 152-77, the Court's *Anti-Inflation* decision represents a more restrictive approach to the former power; *see infra* text accompanying notes 272-90; *but see* W. McConnell, *supra* note 114, at 157. This fact may bring into question the potential impact of the *dicta* in *Vapour Canada*; *see e.g.* [1976] 2 S.C.R. at 437, 458; *but cf.* Laskin, *supra* note 249, at 1078 ("inclined to agree in this result [in the *Snider* case, *supra* note 250] but only because adequate power to regulate industrial relations...ought to be found in the 'trade and commerce' power").

272 *See* S.C. 1974-75-76, c. 75 ("Whereas the Parliament of Canada recognizes that...the containment and reduction of inflation has become a matter of serious national concern").

273 *See* A.G. Can., Factum, May 10, 1978 ¶¶ 6, 8.

274 *See supra* note 271.

275 *See* [1976] 2 S.C.R. at 394-419; as the legislation was justifiable on the basis of a

ing in result,[276] agreed that the legislation could not be sustained otherwise than on an emergency basis and articulated a restrictive doctrine for the availability of Parliament's general power in ordinary circumstances.[277] It is, therefore, reasonable to treat the analysis of the general power in Mr. Justice Beetz's dissenting opinion as the majority view.[278]

The majority in the *Anti-Inflation Reference* does not revert to the earlier view of the Privy Council which effectively limited the use of the "peace, order and good government" clause to situations involving a national emergency.[279] Rather, in attempting to reconcile the decisions of the Privy Council and the Supreme Court of Canada,[280] it propounds a dual approach to the interpretation of Parliament's general power. Federal legislation is justifiable under the general clause either on the basis of an apprehended emergency, including a peacetime crisis,[281] or on the ground that it deals with a matter of national concern.[282] The latter justification, however, is unavailable for legislation concerning broad economic or other areas which are readily divisible for regulatory purposes into categories that have traditionally been included within the provincial heads of jurisdiction in section 92 of the BNA Act.[283] These matters, for example, inflation, labour relations, environmental regulation and economic growth,[284] are subject to

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"crisis", it was unnecessary to consider whether it could also have been supported as a matter of national concern, *id.* at 419, but it is worth noting the Chief Justice's agreement with Lord Watson's advice concerning the exercise of caution in the application of the broader doctrine; *see id.* at 412. Judson, Spence and Dickson, JJ. concurred in the Chief Justice's opinion. *See also* Abel, *supra* note 251, at 432 ("national concern" test the "one with which the plurality flirts and which it would clearly like to adopt").

276 *See* [1976] 2 S.C.R. at 437-39 (*per* Ritchie, J., Martland and Pigeon, JJ., concurring, holding that sufficient evidence that Parliament "motivated by a sense of urgent necessity created by highly exceptional circumstances", *id.* at 439), 459-72 (*per* Beetz, J., de Grandpré, J. concurring, holding that emergency not clearly indicated by Parliament as intended basis of Act).

277 *See id.* at 440-59, *per* Beetz, J.; *see infra* text accompanying notes 283-90.

278 *See id.* at 437, *per* Ritchie, J., indicating agreement with the explication of the scope of Parliament's general power in the dissenting opinion; *but see* Abel, *supra* note 251, at 420-21.

279 *See supra* note 250 and accompanying text.

280 *See supra* text accompanying notes 249-70.

281 *See* [1976] 2 S.C.R. at 412 (*per* Laskin, C.J.), 436 (*per* Ritchie, J.) and 459 (*per* Beetz, J.).

282 *See id.* at 442-59.

283 *See id.* especially at 452-53 (inflation not a self-sufficient category but contains elements of monetary and tax policy and Anti-Inflation Act directed at control of prices, profit margins, dividends and wages aspects of all of which relate "to the regulation of local trade, to contract and to property and civil rights in the provinces"); *see also* P. Hogg, *supra* note 32, at 264-65.

284 The examples derive from the opinion of Mr. Justice Beetz, [1976] 2 S.C.R. at 445 (economic growth, environmental protection, labour relations and business of

the divided jurisdiction of Parliament and the provincial legislatures and their various aspects must be treated within that legislative framework unless an "emergency" exists which temporarily[285] necessitates federal regulation.[286] Matters of national concern in normal circumstances are thus confined to new regulatory areas which do not fall within the traditional classifications and which are "not an aggregate but [have]...a degree of unity that... [makes them] indivisible, an identity which...[makes them] distinct from provincial matters and a sufficient consistence to retain the bounds of form".[287] The impetus underlying this narrow definition of the second branch of the general power is a fear that any other approach would permit Parliament to usurp too easily a jurisdiction that more appropriately belongs to the provincial legislatures,[288] especially as matters of national concern become in effect new heads of federal power.[289] The courts must therefore exercise caution to avoid the addition of "hitherto unnamed powers of a diffuse nature to the list of federal powers".[290]

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insurance), 453 (inflation); *see also* LeDain, *Sir Lyman Duff and the Constitution*, 12 Osgoode Hall L.J. 261, 293 (1974) ("inflation, environmental protection, and preservation of the national identity or independence"); Lederman, *Unity and Diversity in Canadian Federalism: Ideals and Methods of Modernization*, 53 Can. B. Rev. 598, 605, 610-11 (1975) (labour relations, pollution, economic growth and language requirements). Mr. Justice Beetz cited both articles, [1976] 2 S.C.R. at 451-52, and adopted the approach to the general power advocated in the latter at 604-16.

285 All of the opinions stressed the temporary nature of the Anti-Inflation Act and the majority viewed it as an essential quality of legislation enacted to deal with an "emergency"; *see* [1976] 2 S.C.R. at 427 (*per* Laskin, C.J.), 436-37 (*per* Ritchie, J.), 461 (*per* Beetz, J.); *cf.* A.G. Can. v. Dupond, 19 N.R. 478, 495 (S.C.C. 1978) (*per* Beetz, J.).

286 *See* [1976] 2 S.C.R. at 452-53, 458.

287 *Id.* at 458; *see also* LeDain, *supra* note 284; Lederman, *supra* note 284. Examples of matters said to satisfy the test adopted in the decision are the incorporation of companies for other than provincial objects, *see supra* note 251 and accompanying text, the regulation of aeronautics and radio, *see supra* notes 255, 266 and accompanying text, and improvement of the National Capital Region, *see supra* note 268 and accompanying text; [1976] 2 S.C.R. at 457; *see also* Lederman, *supra* note 284, at 605-06 (aviation primary example). *See generally* P. Hogg, *supra* note 32, at 262-65.

288 *See* [1976] 2 S.C.R. at 443-45, 460-64.

289 *See id.* at 461.

290 *Id.* at 458. It is worth noting that the plurality decision too advocated caution in the application of the "national concern" test; *see supra* note 275. As a result, it is not clear whether the plurality and dissenting justices would differ in the application of the test to specific legislation; nevertheless, the differences in tone and approach between the two opinions indicate that differences of application may occur. The fact that only five of the nine justices adopted the dissenting opinion's approach and that the composition of the court has since changed and will continue to change compounds the uncertainty. (In September 1977, Estey and Pratte, JJ. replaced Judson and de Grandpré, JJ.; Spence, Pigeon and Martland, JJ. are due to retire in 1979, 1980 and 1982, respectively.)

Although the dissenting opinion of Mr. Justice Beetz represents the most concrete judicial attempt yet to give content to the concept of "national concern",[291] the criteria indicated by him, perhaps inevitably, provide little more guidance than the more general formulation of the doctrine in the plurality opinion and the earlier cases.[292] Nevertheless, as it is highly unlikely that a federal securities law would be enacted in response to an emergency and as such a law would in any event not be a temporary measure,[293] the "national concern" doctrine is the only basis on which federal regulation of the securities market by Parliament pursuant to its general power may be sustained.

The view adopted by the majority of the Supreme Court requires the application of two criteria, first, whether the matter in question is of sufficient magnitude[294] to exceed provincial regulatory capabilities[295] and thus require regulation on a national basis[296] and, if so, second, whether it is sufficiently specific or distinct to permit such regulation without "destroy[ing] the equilibrium of the Constitution".[297] Although the contours of the

291 *See e.g.* P. Hogg, *supra* note 32, at 263 ("first, and so far the only, attempt by a Canadian judge to reconcile the emergency cases with the national concern cases"); Abel, *supra* note 251, at 430 ("certainly better than anyone else has done").

292 *See* the trenchant criticism in Abel, *supra* note 251, at 426, 429-30, pointing out that the specificity and unity of a particular matter necessarily involves questions of judgment and degree as all matters may be treated as aggregates of submatters and concluding that the "national concern" concept as explicated is "unworkable". This analysis becomes especially telling in light of the fact that aeronautics, now considered by all courts and commentators to be an obvious example of a specific and indivisible matter which must be regulated in a unified manner, *see supra* note 287, was originally treated by the Supreme Court as an aggregate, the intraprovincial elements of which were beyond federal legislative competence; *see* Reference re Regulation and Control of Aeronautics, [1930] S.C.R. 663, *reversed*, [1932] A.C. 54 (P.C. 1931).

293 *See supra* text accompanying notes 285, 286. As Parliament may legislate to prevent an emergency from occurring, as well as to deal with an existing one, *see e.g.* [1976] 2 S.C.R. at 459-60, the impermanence of legislation too is only a matter of degree; *see* P. Hogg, *supra* note 32, at 256.

294 *Cf.* Gibson, *supra* note 248, at 31-32, arguing that the "importance" of a matter is an inappropriate consideration and that the geographic scope, "the *extent* of the area affected" should be determinative; *see also* P. Hogg, *supra* note 32, at 259.

295 *See e.g.* Abel, *supra* note 251, at 434-36; Gibson, *supra* note 248, at 33-36; P. Hogg, *supra* note 32, at 260-61.

296 As the major consideration in the Anti-Inflation Reference was the question of the unity of the subject matter rather than the degree of its "national concern", the factors necessary to indicate when a matter takes on national dimensions received no elaboration; nevertheless, that this standard must be met is implicit in Mr. Justice Beetz's opinion, *see* [1976] 2 S.C.R. at 453-54, 457, and is expressed in the article which was effectively adopted as the basis of the opinion; *see* Lederman, *supra* note 284, at 606 ("something that necessarily requires country-wide regulation at the national level").

297 [1976] 2 S.C.R. at 458; *see also* Lederman, *supra* note 284, at 606.

former standard remain vague,[298] the regulation of the securities market arguably meets all of the criteria likely relevant to its application. As was outlined above,[299] the securities market is not only national but international in scope.[300] It thus transcends provincial boundaries both geographically[301] and in its regulatory needs as the provinces lack the ability to enact, even cooperatively, a comprehensive regulatory scheme.[302] And the increasing use of automation in the market exacerbates all of these factors.[303] It is but a small step to infer from these facts that the regulation of the Canadian securities market is a matter of national concern. Nevertheless, even though there is an "interrelated" and "overarching pattern of activities" in the market, it is difficult to demonstrate that "harmonious provincial action cannot provide a frame of control",[304] especially as the provinces have regulated the securities market for at least a third of a century in a manner that is generally considered reasonably effective.[305] As a result, despite the regulatory gaps in provincial powers, it may be difficult to convince the Court that a comprehensive federal regulatory scheme rather than legislation of an interstitial character is neces-

298 *See supra* note 296.

299 *See supra* ch. I.

300 *See supra* text accompanying notes 7-19. International obligations on the part of Canada have exerted a significant influence on the characterization of legislation as being directed at a matter of national concern; *see e.g.* Gibson, *supra* note 248, at 29-30, 32-33; similar arguments can be applied to the securities market; *see e.g.* Denison Mines Ltd. v. A.G. Can., [1973] 1 O.R. 797, 808-09 (H.C.); *see also supra* text accompanying notes 15-19; and *see generally, Hebenton and Gibson.*

301 *See supra* note 294.

302 *See supra* text accompanying notes 53-90; *see also supra* note 295 and accompanying text.

303 *See supra* text accompanying note 12 and following; *see also supra* ch. III.C.

304 Abel, *supra* note 251, at 436. It has long been accepted that a desire for a uniform solution to a nationwide problem is not alone sufficient to constitute a matter one of national concern; *see e.g.* Abel, *supra* note 251, at 434; Gibson, *supra* note 248, at 32; P. Hogg, *supra* note 32, at 259-60; *see also supra* note 248. Indeed, although the *Russell* decision was upheld by the Privy Council because of its longevity, *see* A.G. Ont. v. Canada Temperance Federation, [1946] A.C. 193, 206 (P.C.), recent commentators have universally concluded that it was wrongly decided; *see e.g.* Abel, *supra* at 422-23; Gibson, *supra* note 248, at 32; P. Hogg, *supra* note 32, at 265.

305 Although the first provincial securities legislation was enacted almost 70 years ago, *see supra* note 34, the provincial acts from 1928 to 1945 merely required brokers and dealers to obtain a licence before trading in securities; 33 years ago, in 1945, provisions requiring the filing and acceptance of a prospectus in connection with a distribution of securities were added to the Ontario Securities Act; *see* Security Frauds Prevention Act, S.O. 1928, c. 34; Securities Act, 1945, S.O. 1945 (2d Sess.), c. 22. The development of the Ontario legislation from 1928 to 1966 is described in P. Anisman, *supra* note 81, at 25-42; *see also* J. Williamson at 20-28, 30-34; J. Williamson, Supp. at 2-6.

sary, especially in light of the restrictive inclinations evinced in the *Anti-Inflation Reference*.[306]

Similar difficulties are likely to be encountered in connection with the distinctiveness of the securities market as a subject matter of federal legislation.[307] Although the securities market, especially when contrasted with "economic growth",[308] may be viewed as a unified entity with an identity sufficiently distinct to avoid potential smothering of provincial powers,[309] it is far from clear that the Court would not view it as an "aggregate" of matters traditionally within provincial jurisdiction.[310] Despite the fact that the securities market as a legislative subject matter is substantially more "specific" and less "pervasive" than inflation,[311] the likelihood of its characterization as an "aggregate" is increased by the existence of provincial legislation which has been held to come within subsection 92(13) of the BNA Act by both the Supreme Court and the Privy Council.[312] In other words, the previous decisions upholding provincial securities legislation gravitate against characterization of the securities market as a "new subject matter" not encompassed by section 92.[313]

In short, while there are sound arguments in favour of characterizing the securities market as a matter of national concern within Parliament's legislative jurisdiction, countervailing arguments exist as well and certainty in predicting which would prevail is impossible. Indeed in light of the substantial doubt over the potential success of the former line of argument and of the Supreme Court's expressed antipathy toward an expansive interpretation of the general power, it would be advisable not to rely exclusively, if at all, on "the peace, order, and good government of

306 *See supra* text accompanying notes 276-90. This conclusion differs from that of one of the present authors in respect of the regulation of mutual funds by Parliament; *see* Hogg, *Appendix: The Constitutionality of Federal Regulation of Mutual Funds*, in 1 Mutual Fund Proposals 75, 81. However, that opinion was written in 1974 before the Supreme Court restricted the scope of the "national concern" test.

307 *See supra* text accompanying note 287.

308 *See supra* note 284 and accompanying text.

309 *See* [1976] 2 S.C.R. at 458; *see also supra* note 287.

310 *See* [1976] 2 S.C.R. at 458.

311 *See id.* (inflation "is an aggregate of several subjects some of which form a substantial part of provincial jurisdiction. It is totally lacking in specificity. It is so pervasive that it knows no bounds. Its recognition as a federal head of power would render most provincial powers nugatory"). *See also supra* text accompanying note 308.

312 *See supra* notes 34-50 and accompanying text. The fact that the provincial legislation is directed at transactions in securities in the province may exert an independent influence on the characterization; *see also supra* text accompanying notes 134-37, 181-213.

313 *See supra* text accompanying note 289; *see also* [1976] 2 S.C.R. at 450-53, 458. This

Canada" as a basis for federal securities legislation. As is indicated above, the better support is the power to regulate trade and commerce, possibly in conjunction with that over interprovincial works and undertakings.[314]

E. THE CRIMINAL LAW POWER

A federal securities law will undoubtedly contain prohibitions against market manipulation and other types of fraud in connection with securities trading as well as a general prohibition against any other violation of its requirements.[315] Indeed, it is likely that it would incorporate the provisions of the Criminal Code dealing specifically with fraudulent conduct relating to securities transactions, which would simultaneously be deleted from the Code, and would also add a number of provisions to preclude other deceptive practices and improper market conduct.[316] It is, therefore, worth considering Parliament's power to legislate in relation to criminal law as a further basis upon which a federal securities act might be supported.[317]

Despite the difficulty of defining the outer reaches of the "criminal law",[318] the courts have generally declared that Parliament's power to legislate extends to "the criminal law in its widest sense"[319] and there is no doubt that it enables the prohibition of "undesirable commercial practices", as well as of violence, immo-

type of argument could not have been made in connection with aeronautics, radio or a national capital region; *see supra* notes 255, 266, 268.

314 *See supra* ch. III.B, C. While securities legislation that comes within the general power would necessarily also meet the requirements for "general trade and commerce", the converse is not true; *compare supra* text accompanying notes 140-79 with that accompanying notes 266-90. Therefore, reliance on the power to regulate trade and commerce is also preferable as a tactical matter.

315 *See generally, Leigh*, ch. II.

316 *See id.*; and *see supra* text accompanying notes 103-05.

317 *See* BNA Act, s. 91(27) ("The Criminal Law, except the Constitution of Courts of Criminal Jurisdiction, but including the Procedure in Criminal Matters").

318 *See e.g.* P. Hogg, *supra* note 32, at 278-81. Recent decisions of the Supreme Court indicate that the matter of definition is far from resolution; *see e.g.* N.S. Bd. of Censors v. McNeil, 19 N.R. 570 (S.C.C. 1978); A.G. Can. v. Dupond, 19 N.R. 478 (S.C.C. 1978).

319 A.G. Ont. v. Hamilton Street Ry., [1903] A.C. 524, 529 (P.C.). The initial broad reading of subsection 91(27) was, like other federal heads of power, contracted by the Privy Council during the 1920s, *see In re* Board of Commerce Act, 1919, [1922] 1 A.C. 191, 198-99 (P.C. 1921), and readopted in the 1930s; *see* Proprietary Articles Trade Assn. v. A.G. Can., [1931] A.C. 310, 323-25 (P.C.). For more detailed discussion of the power's judicial history, *see e.g.* Laskin, *supra* note 35, at 822-24; P. Hogg, *supra* note 32, ch. 16. It is now clear that the criminal law power provides a flexible concept capable of adaptation to changing circumstances; *see e.g.* R. v. Zelensky, 2 C.R. (3d) 107, 115-16 (S.C.C. 1978).

rality and other forms of vice.[320] In fact, the primary constitutional support for Canadian antitrust legislation has been the criminal law power;[321] not only have the prohibition of combines[322] and amendments prohibiting price discrimination[323] and resale price maintenance[324] been upheld under this head, but it has also been interpreted as sufficiently broad to support injunctive remedies against the prohibited practices.[325]

It is therefore clear that Parliament has plenary jurisdiction to prohibit and penalize manipulative conduct and to proscribe as well any other activities in the securities market that it considers undesirable. If there were any doubt concerning this authority, it was put to rest when the Supreme Court in 1960 unanimously upheld the Criminal Code's prohibition against making, circulating or publishing a false prospectus.[326] The transplanted provisions of the Criminal Code and other offences in a federal securities act would thus constitute a valid exercise of the criminal law power.[327]

A more difficult question is whether the same head of power would also provide support for the parts of a federal law that do not directly create offences. As was said above,[328] the purpose of securities legislation is not only to prevent fraud but also to ensure that investors have confidence in the fair operation of the securities market by means of disclosure of information and regulation of market actors. Any modern securities act must therefore include disclosure requirements both in connection with distributions of securities and by issuers on a continuing basis,[329] a scheme for supervising the conduct of market actors by licensing, self-regulation or both,[330] and an administrative mechanism to interpret and enforce its provisions.[331] Such provisions will invariably

320 LASKIN, *supra* note 35, at 824.

321 *See e.g.* P. HOGG, *supra* note 32, at 281-85; *see also* McDonald, *Constitutional Aspects of Canadian Anti-Combines Law Enforcement*, 47 CAN. B. REV. 161, 166-84 (1969); Hogg & Grover, *The Constitutionality of the Competition Bill*, 1 CAN. BUS. L.J. 197, 202-05 (1976); S. GRANGE, THE CONSTITUTIONALITY OF FEDERAL INTERVENTION IN THE MARKETPLACE - THE COMPETITION CASE 20-22 (undated).

322 *See* Proprietary Articles Trade Assn. v. A.G. Can., [1931] A.C. 310 (P.C.).

323 *See* A.G.B.C. v. A.G. Can., [1937] A.C. 368 (P.C.).

324 *See* R. v. Campbell, 58 D.L.R. (2d) 673 (S.C.C. 1965).

325 *See* Goodyear Tire & Rubber Co. of Canada Ltd. v. R., [1956] S.C.R. 303. It appears that a "consent decree" procedure may be developing in connection with the injunctive remedy; *see* R. v. Canada Safeway Ltd., [1974] 1 W.W.R. 210 (Alta. S.C. 1973).

326 *See* Smith v. R., [1960] S.C.R. 776; *see also* Criminal Code, s. 358.

327 *Cf. e.g.* ALI FEDERAL SECURITIES CODE, pt. XVI; and *see id.* ss. 909-16.

328 *See supra* ch. III.A.

329 *See e.g. Grover & Baillie.*

330 *See e.g. Connelly; Dey & Makuch.*

331 *See e.g. Howard; Leigh.*

involve the imposition of positive duties on issuers, brokers, dealers, self-regulatory organizations and other persons trading in securities and will likely involve as well extensive rule-making powers enabling an administrator to refine the general standards in the legislation and to specify the content of documents required to be filed and circulated.[332] And to be effective a securities act must also include a comprehensive system of civil liability so that persons who are harmed by a violation of or failure to comply with the act's requirements may be compensated.[333]

In short, criminal prohibitions would form only one part of a comprehensive scheme for the regulation of the securities market and not necessarily the dominant part. The disclosure and other regulatory provisions of a securities act go far beyond the boundaries usually assigned to the criminal law.[334] The courts have consistently held that the criminal law is not a sufficient peg upon which to support a regulatory structure[335] and have looked through form to the substance of legislation in order to determine its true character.[336] In doing so they have declared invalid, as "colourable" attempts to exceed Parliament's legislative jurisdiction,[337] apparently criminal provisions creating an offence for a person to act on behalf of an insurance company without a federal licence[338] or to offer, sell or possess butter substitutes such as margarine.[339] And the laws which have been upheld under subsection 91(27) have confined the enforcement powers of the agency to investigating, reporting, recommending and prosecuting, all matters that are clearly related to criminal law.[340] As a result it is

332 *See e.g.* Ontario Securities Act, pts. II, VII; Canada Business Corporations Act, s. 254(1)(c).

333 *See generally, Leigh*, ch. II.B; *see also e.g.* ALI Federal Securities Code, pt. XVII. Constitutional considerations relating to civil remedies are discussed *infra* ch. III.F.

334 *See generally* P. Hogg, *supra* note 32, at 289-91.

335 *See e.g. In re* Board of Commerce Act, 1919, [1922] 1 A.C. 191, 198-99 (P.C. 1921); Reference re Dominion Trade and Industry Commission Act, 1935, [1936] S.C.R. 379, 381, *affirmed*, [1937] A.C. 405, 416 (P.C.) (approval of agreements in specific industry in which competition wasteful not ancillary to criminal law). Although no arguments were directed to the provision in question before the Judicial Committee, the opinion expressly states its agreement with the Supreme Court's holding.

336 On the characterization of the nature of legislation, *see generally* Laskin, *supra* note 35, at 98-121; P. Hogg, *supra* note 32, at 80-88.

337 On "colourability" *see e.g.* Laskin, *supra* note 35, at 101-02; P. Hogg, *supra* note 32, at 86-87.

338 *See* A.G. Ont. v. Reciprocal Insurers, [1924] A.C. 328 (P.C.); on the history of the insurance decisions of the Privy Council, *see* P. Hogg, *supra* note 32, at 299-301.

339 *See* Canadian Federation of Agriculture v. A.G. Que., [1951] A.C. 179, 195-97 (P.C. 1950) (purpose of provision to regulate trade; not criminal law).

340 *See e.g.* Proprietary Articles Trade Assn. v. A.G. Can., [1931] A.C. 310 (P.C.); and *see supra* note 335. Recent amendments to the Combines Investigation Act have extended its provisions to include civil remedies and give adjudicative powers to the Restrictive Trade Practices Commission; *see* S.C. 1974-75-76, c. 76. On the constitu-

unlikely that the criminal provisions outlined above, or for that matter a general provision creating an offence and prescribing penalties for a violation of any provision of the act,[341] would be sufficient to give a criminal law cast to a federal securities law.

Thus while Parliament's power to legislate in relation to criminal law would support the part of a securities law proscribing and providing penalties for fraudulent and other improper conduct,[342] the justification for the remaining parts of the law would have to be sought elsewhere.[343]

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tionality of these amendments, *see* S. GRANGE, *supra* note 321; Hogg & Grover, *supra* note 321.

Some doubt may be cast on the ability of a federal agency to engage in enforcement activities by Re Hauser, 80 D.L.R. (3d) 161 (Alta. App. Div. 1977), which held the prosecutorial function beyond Parliament's jurisdiction under the BNA Act, s. 91(27) on the basis that it is a matter of the administration of justice and thus within exclusive provincial jurisdiction under s. 92(14). The decision would preclude the prosecution for violations of the criminal provisions of a federal securities act by a federal agency and thus would limit the agency's ability to determine its own enforcement policies. There are, however, contrary holdings in other courts of equivalent jurisdiction, *see e.g.* R. v. Pelletier, 4 O.R. (2d) 677 (C.A. 1974), *leave to appeal refused*, [1974] 2 S.C.R. x, and the Supreme Court of Canada granted leave to appeal the *Hauser* decision on January 26, 1978, and heard argument on it on May 29-31, 1978.

The decision in *Hauser* is inconsistent with previous decisions which have held investigatory functions ancillary to the criminal law power, *see e.g.* A.G. Ont. v. A.G. Can., [1937] A.C. 405, 416 (P.C.); Proprietary Articles Trade Assn. v. A.G. Can., *supra*, for no rational distinction can be drawn between investigative and prosecutorial functions; both are equally a part of the administration of justice and equally relate to the effectiveness of criminal laws enacted by Parliament; *see e.g.* Di Iorio v. Warden of the Common Jail of Montréal, 73 D.L.R. (3d)491 (S.C.C. 1976); *cf.* Toronto v. R., [1932] A.C. 98, 103-04 (P.C. 1931) (power to direct recipient of fines ancillary to criminal law as may go to efficacy of legislation). Similarly the majority of the Alberta Court drew an arbitrary distinction between the enforcement of criminal law and the enforcement of laws enacted by Parliament pursuant to other heads of power; *see* Re Hauser, *supra*, at 173, 188; *cf.* Di Iorio v. Warden, *supra*, at 497-98 (*per* Laskin, C.J., dissenting), 529 (*per* Dickson, J. for majority). However, injunctive and other remedial proceedings by a government agency responsible for the administration and enforcement of a regulatory statute may be as much a part of the "administration of justice" as the enforcement of the criminal law; and as provincial jurisdiction over the administration of justice is broader under s. 92(14) in relation to civil than to criminal justice, the implications of *Hauser* may be far reaching indeed. In short, it appears that the *Hauser* Court gave insufficient weight to the implications of its decision, as well as to the implications of the exception in s. 91(27).

It is, therefore, unlikely that the Supreme Court will affirm the Appellate Division's decision. Rather, it is likely to conclude that the validity of legislation governing the prosecutorial, as well as other enforcement, functions depends upon the aspect from which it was enacted and that jurisdiction over them is concurrent; *see* Di Iorio v. Warden, *supra*, at 529 (*per* Dickson, J.), 542-43 (*per* Beetz, J.); and *see generally* P. HOGG, *supra* note 32, at 84-85.

341 *See e.g.* Canadian Federation of Agriculture v. A.G. Que., *supra* note 339; *cf.* MacDonald v. Vapour Canada Ltd., 66 D.L.R. (3d) 1, 10-11 (S.C.C. 1976).

342 In light of the difficulties of accurately predicting constitutional validity, it might be advisable to include the criminal prohibitions as a separate, and severable, part

F. CIVIL REMEDIES

The criminal law provides a technique for the enforcement of a regulatory statute that is necessarily limited both in incidence and in deterrent capability.[344] Criminal penalties by definition may be imposed only after an offence has been detected and proved. The deterrent effect of a fine or even imprisonment, especially in the case of economic crimes where the potential risks of a violation are likelier to be evaluated rationally,[345] will be diluted by the likelihood that the violation will go undetected, a factor which is influenced by the enforcement budget of the authority administering the legislation, and further by the fact that a criminal offence, even if discovered, imposes a heavy burden of proof on the prosecution,[346] and particularly so in connection with offences involving complex technical or financial activities.[347] Modern securities laws, therefore, place substantial reliance on other remedial devices which may be initiated by an administrative authority or by private litigants. Injunctive and other civil enforcement actions by a government agency permit preventative measures involving a lesser burden of proof than a criminal prosecution[348] and the availability of civil actions for damages by persons who suffer harm as a result of a violation both enhances the deterrent effect of the legislation and enables compensation to the plaintiff for his injury.[349] Indeed, the public benefits of private actions derive largely from the economic interest of the plaintiff in obtaining compensation for the effects of the violation.[350]

A federal securities act will, therefore, undoubtedly contain provisions creating civil liability for a false prospectus[351] and for false statements in other required documents such as takeover bid

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of a federal act, especially if the equivalent provisions in the Criminal Code are to be repealed when federal securities legislation is enacted. Severability is discussed *infra* ch. III.G.

343 *See supra* ch. III.B, C.

344 *See generally, Leigh*, ch. II.

345 *See e.g. id.* text accompanying notes 26-28.

346 *See e.g.* McDonald, *supra* note 321, at 163-65; P. ANISMAN at 306-07.

347 *See e.g.* R. v. Lampard, [1968] 2 O.R. 470 (C.A.), *reversed*, [1969] S.C.R. 373.

348 *See generally, Leigh*, ch. II.C-E; *see also e.g.* ALI FEDERAL SECURITIES CODE, s. 1819 and Notes. Constitutional questions relating to enforcement activities are discussed *supra* note 340; *see also* McDonald, *supra* note 321, at 210-25.

349 *See e.g. Leigh*, text accompanying notes 71-73; P. ANISMAN at 307.

350 *Cf. e.g.* J.I. Case Co. v. Borak, 377 U.S. 426 (1964).

351 *See e.g.* Ontario Securities Act, ss. 65, 142; Ontario Bill 7, s. 126; ALI FEDERAL SECURITIES CODE, s. 1704; and *see generally, Leigh*, text at note 88 and following.

and proxy circulars[352] and perhaps even annual reports.[353] And it would be surprising if it does not include as well civil remedies for fraudulent and other prohibited conduct such as insider trading[354] and manipulation of the market price of a security.[355] Such actions must form an essential part of any regulatory scheme and will also serve to bolster confidence in the fair operation of the securities market.[356]

If federal legislation is, as suggested above, based on Parliament's power to regulate trade and commerce or interprovincial works and undertakings,[357] the provision of civil actions for damages and other remedies will create no constitutional difficulties, regardless of whether they are premised on a violation of the criminal and other prohibitions in the act or are individually specified in a separate part;[358] their connection with the purpose and implementation of the legislation as a whole is clearly both rational and functional.[359] In other words, a system of civil remedies to reinforce the requirements of a securities act[360] is necessar-

352 *See e.g.* Ontario Securities Act, ss. 100(a), 144(a); Ontario Bill 7, s. 127; Canada Business Corporations Act, ss. 148, 198(3), 234; ALI Federal Securities Code, s. 1713. The provisions of the Ontario Act relating to prospectuses and takeover bid circulars are criticized in P. Anisman at 320-27; *see also* D. Johnston at 180-86, 341-42.

353 *See e.g.* ALI Federal Securities Code, s. 1704; *see also id.* s. 1705 (false filings).

354 *See e.g.* Canada Business Corporations Act, s. 125; Ontario Securities Act, ss. 113-14; Ontario Bill 7, ss. 131-32; ALI Federal Securities Code, s. 1703. The provision in the Ontario Bill was substantially modified in committee; *see* Third reading, June 23, 1978. On insider trading generally, *see, Yontef; Anisman; Leigh*, text accompanying notes 90-94.

355 *See e.g.* ALI Federal Securities Code, s. 1710; *see generally, Leigh*, text following note 94. The ALI Code provides a remedy for open market transactions involving fraud and manipulation, including insider trading; as a result, it does not require a contractual relationship to exist between a plaintiff and defendant as the Ontario legislation does; *see* Ontario Bill 7, *supra* note 354. It is arguable that Bill 7 is in this regard more limited than the present Ontario legislation; *see, Anisman* at 234-43.

356 *See supra* chs. I, III.A.

357 *See supra* ch. III.B, C.

358 *Cf.* MacDonald v. Vapour Canada Ltd., 66 D.L.R. (3d) 1 (S.C.C. 1976) in which the Supreme Court held invalid a provision creating civil liability for essentially tortious conduct which was wholly unrelated to the scheme of the act in which it was contained; *see id.* at 10-11, 25; *see also supra* text accompanying notes 152-58. And *cf.* Weider v. Beco Industries Ltd., 29 C.P.R. (2d) 175 (F.C.T.D. 1976) (following *Vapour Canada* in respect of application of Trade Marks Act, R.S.C. 1970, c. T-10, s. 7(b) to patents). The fact that all of the provisions creating civil liability are segregated from the other provisions on which the liability is based, that is, are included in a single part of the act, would not alone lead to the conclusion that they are unrelated to the rest of the act in the sense used in the *Vapour Canada* decision for the analysis in the case emphasized substance over form, *see* 66 D.L.R. (3d) at 8, 26-27, and clearly indicated that civil remedies that "round out regulatory schemes...in relation to patents, copyrights and trade marks" would be valid; *id.* at 31.

359 *See* Papp v. Papp, 8 D.L.R. (3d) 389, 393-94 (Ont. C.A. 1969).

360 *See supra* text accompanying notes 348-50.

ily incidental to the achievement of its objects.[361] Judicial decisions concerning a number of disparate matters such as federal elections,[362] railways,[363] federal corporations[364] and even divorce[365] have upheld Parliament's jurisdiction to provide civil relief in order to effectuate its legislative policies.[366]

Apprehension over the validity of such provisions, however integral to the regulatory scheme, need arise only if the basis of the statute is the criminal law power.[367] Because criminal law involves the prohibition of conduct that is considered undesirable and the specification of penalties for a violation,[368] it is arguable that any attempt to ascribe civil consequences to such conduct is beyond Parliament's jurisdiction under subsection 91(27) and necessarily constitutes an invasion of the exclusive provincial preserve labelled "property and civil rights".[369] While this conceptual approach has been adopted by some judges,[370] the Supreme Court

361 On the ancillary doctrine generally, *see supra* citations in note 125.

362 *See* Doyle v. Bell, 11 O.A.R. 326 (C.A. 1884).

363 *See* Curran v. Grand Trunk Ry. Co. of Canada, 25 O.A.R. 407 (C.A. 1898) (right of action for breach of Railway Act); Grand Trunk Ry. Co. of Canada v. A.G. Can., [1907] A.C. 65 (P.C. 1906) (regulation of employer-employee relationship); Greer v. Canadian Pacific Ry. Co., 51 S.C.R. 338 (1915); Canadian Northern Ry. Co. v. Pszenicnzy, 54 S.C.R. 36 (1916); Williams v. Canadian National Ry. Co., 75 D.L.R. (3d) 87, 89-91 (N.S.C.A. 1976) (limitation period). *See now e.g.* Railway Act, R.S.C. 1970, c. R-2, ss. 86 (contracts respecting rolling stock), 185 (wages), 294 (contracts limiting liability), 336 (breach of duty under Act creates cause of action for damages) and 397 (vicarious liability).

364 *See* Esso Standard (Inter-America) Inc. v. J.W. Enterprises Inc., [1963] 2 S.C.R. 144, 152-53 (dictum); *cf.* Multiple Access Ltd. v. McCutcheon, 78 D.L.R. (3d) 701 (Ont. Div'l Ct. 1977), *affirmed* (Ont. C.A. June 14, 1978, unreported) (jurisdiction assumed, 78 D.L.R. (3d) at 703).

365 *See* the recent series of decisions upholding the corollary relief provisions of the Divorce Act of 1968, S.C. 1967-68, c. 24, now R.S.C. 1970, c. D-8; Papp v. Papp, 8 D.L.R. (3d) 389 (Ont. C.A. 1969) (custody); Jackson v. Jackson, [1973] S.C.R. 205 (1972); Zacks v. Zacks, [1973] S.C.R. 891 (maintenance); on divorce and ancillary matters generally, *see* P. Hogg, *supra* note 32, at 371-76.

366 *See also* Nykorak v. A.G. Can., [1962] S.C.R. 331 (Parliament may impose liability to federal Crown on person who injures member of armed forces); on tort liability of the federal Crown under federal legislation, *see* P. Hogg, *supra* note 32, at 169-71. *See also* Combines Investigation Act, R.S.C. 1970, c. C-23, s. 31.1, added by S.C. 1974-75-76, c. 76, s. 12, creating an action for damages for specified breaches of the Act. There has been some difference of opinion over the validity of the new remedy, *see* S. Grange, *supra* note 321, at 35-37 (invalid); Hogg & Grover, *supra* note 321, at 207-09, but the issue has not yet received judicial consideration; *cf.* Eli Lilly & Co. v. Marzone Chemicals Ltd., 29 C.P.R. (2d) 255 (F.C.A. 1976) (refusal to hear argument on issue when not raised in lower court).

367 *See supra* ch. III.E.

368 *See e.g.* Proprietary Articles Trade Assn. v. A.G. Can., [1931] A.C. 310, 324 (P.C.); *cf.* H. Packer, The Limits of the Criminal Sanction 17-19 (1968).

369 BNA Act, s. 92(13), on property and civil rights generally, *see* P. Hogg, *supra* note 32, ch. 17.

370 *See e.g.* R. v. Zelensky, 2 C.R. (3d) 107, 140-47 (S.C.C. 1978) (*per* Pigeon, J. dissenting); *see also* Ross v. Registrar of Motor Vehicles, [1975] 1 S.C.R. 5, 13 (1973) (civil

has not been so restrictive. Rather it has directed its attention to the primary characteristics of the legislation under consideration[371] and where the statute was within Parliament's criminal law power, the Court has considered the functional relationship between the act as a whole and the provision establishing the civil consequences flowing from its violation.[372] Thus provisions authorizing injunctive and compensatory orders after a criminal conviction have been upheld as furthering the purpose of the offence with which they are connected.[373] And although the former type of order was treated as a supplementary sanction[374] and the latter as part of the sentencing process,[375] the approach adopted by the Supreme Court in both cases provides a basis for the creation by Parliament of civil remedies as an enforcement technique to supplement the more traditional criminal sanction.[376] The availability of such remedial methods of enhancing the effectiveness of criminal prohibitions is reinforced by the Supreme Court's declaration that there is no constitutional impediment to the implication of a civil cause of action on behalf of a person who suffers harm from

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consequences of criminal act not "punishment"); and *see* Pollock v. Lipkowitz, 17 D.L.R. (3d) 766, 767 (Man. Q.B. 1970) (dictum that Parliament lacks authority to abolish tort action for damages against juvenile delinquent); *cf.* LASKIN, *supra* note 35, at 835.

371 *See supra* notes 336-38 and accompanying text; MacDonald v. Vapour Canada Ltd., 66 D.L.R. (3d) 1 (S.C.C. 1976); and *see supra* note 358.

372 *See supra* notes 361-65 and accompanying text.

373 *See* Goodyear Tire & Rubber Co. of Canada Ltd. v. R., [1956] S.C.R. 303 (prohibition of continuation or repetition of offence); R. v. Zelensky, 2 C.R. (3d) 107 (S.C.C. 1978) (compensation for loss or damage suffered as result of indictable offence).

374 *See* [1956] S.C.R. at 308 (prohibitory order authorized "in addition to any other penalty").

375 *See* 2 C.R. (3d) at 119-25. In fact, in order to emphasize the relationship between an order for compensation and sentencing the Chief Justice created an unnecessary and rather questionable standard by suggesting that a court should have regard to the motives of the applicant in determining whether to make an order even accepting that an order "should only be made with restraint and caution". Whether a particular applicant wishes to "emphasize the sanctions against the offender", *id.* at 125, or merely to recover the value of what he lost is irrelevant to the effect of the provision enacted by Parliament and also to whether an order should be granted; a compensation order could not have been intended to benefit only those who seek retribution; *cf. id.* at 121, quoting from Re Torek, 44 D.L.R. (3d) 416, 419 (Ont. H.C. 1974) (valid object "to prevent convicted criminal from profiting from his crime"); and *cf.* Affiliated Ute Citizens of Utah v. U.S., 406 U.S. 128, 155 (1972) (if defendant's profit greater than plaintiff seller's loss, damages are amount of profit).

376 The majority opinion in the *Goodyear* case contained a broad statement of principle to justify the prohibitory order; *see* [1956] S.C.R. at 308 ("The power to legislate in relation to criminal law is not restricted...to defining offences and providing penalties for their commission. The power of Parliament extends to legislation designed for the prevention of crime as well as to punishing crime"). And although the tone of the majority in *Zelensky* is at best cautious, the decision rests on a straightforward application of the ancillary doctrine; *see* 2 C.R. (3d) at 119-20, citing Papp v. Papp, *supra* note 365.

the violation of a criminal statute;[377] for if a remedy may be implied by the courts, it may be expressly created by Parliament.[378]

The issue may be illustrated by the example of insider trading in the securities of non-public corporations.[379] As securities legislation is directed at public trading in securities, it is concerned almost exclusively with corporations that sell securities to the public and tends to exempt or ignore other issuers.[380] As a result, the provisions of the securities acts proscribing and creating civil liability for insider trading apply only to public corporations[381] even though the vast majority of corporations are private[382] and

377 *See* Direct Lumber Co. Ltd. v. Western Plywood Co. Ltd., [1962] S.C.R. 646, 649-50; *cf.* Joyal v. Air Canada, [1976] C.S. 1211 (injunction against continued breach of Official Languages Act, R.S.C. 1970, c. O-2); Magee v. Channel Seventynine Ltd., 75 D.L.R. (3d) 201 (Ont. H.C.) (dismissing action for breach of contract made in violation of Lord's Day Act, R.S.C. 1970, c. L-13).

378 The dictum in *Direct Lumber* might be explained as indicating that an implied cause of action is not a statutorily created right but a matter of common law; *see e.g.* London Passenger Transport Bd. v. Upson, [1949] 1 A.C. 155, 168 (H.L. 1948), cited with approval in Sterling Trusts Corp. v. Postma, [1965] S.C.R. 324, 329; *see also* Finkelman, *Comment: Industrial Law - Combines Legislation - Conspiracy - Right of Injured Party to Sue for Damages for Breach of Criminal Statute*, 13 CAN. B. REV. 517, 521-22 (1935); P. ANISMAN at 316-17. But the majority of the courts have tended to treat the implication of a civil remedy as a matter of legislative intent; *see e.g.* J. FLEMING, THE LAW OF TORTS 123-24 (5th ed. 1977). However, neither interpretation of the decision detracts from the conclusion in the text for even if the common law of tort be treated as within provincial jurisdiction under s. 92(13) of the BNA Act, *see e.g.* B. LASKIN, THE BRITISH TRADITION IN CANADIAN LAW 127 (1969); Finkelman, *supra; Leigh*, text accompanying note 115, the implication of a civil remedy in tort in accordance with common law principles necessarily involves a conclusion that the remedy is ancillary to the legislation; *see generally* J. FLEMING, *supra* at 122-33; P. ANISMAN at 314-18; *Leigh*, text accompanying notes 110, 119-30. As a result, if a matter of common law, it is federal; *see e.g.* LASKIN, *supra* note 35, at 793 ("is federal common law...and provincial common law...according to the matters respectively distributed to each legislature"); B. LASKIN, *supra*, at 129-30; Hogg, *Comment: Constitutional Law - Limits of Federal Court Jurisdiction - Is There a Federal Common Law*, 55 CAN. B. REV. 550 (1977).

379 On insider trading generally *see*, *Yontef*; *Anisman*. For purposes of the present discussion "insider trading" is intended to connote transactions in securities by a person who is in possession of material undisclosed information relating either to the issuer or the securities themselves; *see e.g. Anisman* at 154-55.

380 *See e.g.* Ontario Securities Act, ss. 19(1)9a, 19(2)9, 81(a)(iii), 101(a), 109(1)(b), 118(1)(b) (all exempting or excluding transactions in and reporting by private companies); Ontario Bill 7, ss. 1(1)38 ("reporting issuer"), 34(2)10, 72(1)(a), 74, 88(2)(b).

381 *See e.g.* British Columbia Securities Act, ss. 106(1)(b), 111; Ontario Securities Act, ss. 109(1)(b), 113; Ontario Bill 7, ss. 75, 131. *But see* Canada Business Corporations Act, s. 125; Companies Act, S.B.C. 1973, c. 18, s. 152 (all corporations). Rule 10b-5 under the Securities Exchange Act of 1934 also applies to transactions in securities of closely held corporations; *see e.g.* Arber v. Essex Wire Corp., 490 F.2d 414 (6th Cir. 1974), *cert. denied*, 419 U.S. 830 (1974).

382 *See e.g. Anisman* at 209 n. 359 (generally over 90% in all jurisdictions). "Private" corporations are here treated as synonymous with closely held corporations; *cf. e.g.*

even though most of the reported instances of insider trading have involved closely held corporations.[383] A federal securities act too is likely to be concerned primarily with public issuers not only for substantive reasons but also because justification for regulating closely held corporations the securities of which are almost invariably traded exclusively intraprovincially in face-to-face transactions is substantially more difficult under the BNA Act.[384]

Nevertheless, insider trading in the securities of any issuer arguably should be prohibited; although the market impact may differ, the "vice" is the same whether or not the issuer is a public corporation.[385] And it would be surprising indeed if a federal act prohibiting insider trading did not create civil liability for a violation of its provisions.[386] The legislation might, therefore, include a civil remedy for insider trading in the securities of both public and private corporations.[387] However, while liability in respect of the former type of corporation would further the market purpose of the act,[388] the remedy for persons trading in securities of closely held corporations would not do so; rather it would flow exclusively from the criminal prohibition and would have to be sustained on that basis.

As insider trading in the securities of a private corporation would have no market impact, it would not be the subject of an administrative agency's normal surveillance procedures. Such violations would come to the attention of the enforcement agency only when a complaint is filed by an aggrieved person and the initiation of proceedings in such cases would not only be costly but, more important, would divert the agency from its primary duty, the regulation of the public market.[389] A provision creating civil

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Ontario Securities Act, s. 1(1)14; Ontario Bill 7, s. 1(1)31 ("private company" one the constitution of which limits number of shareholders, restricts right to transfer its shares and prohibits public offering of securities).

383 *See e.g. Anisman* at 209-10 nn. 360, 361; P. Anisman at 118 n. 292.

384 *See supra* ch. III.B.

385 *See e.g. Anisman* at 209-10. In fact, it might be thought that the direct dealing involved in trading in the securities of private corporations makes insider trading in such transactions more culpable from a moral perspective than trading in an organized market where the harm is less tangible; *see e.g. Anisman* at 235-36; *but see id.* at 236-38. In any event, the distinction seems to be reflected in the case law; *see id.* at 155 n. 17, 167; Goodwin v. Agassiz, 186 N.E. 659 (Mass. S.C. 1933); *cf.* R. v. Littler, 13 C.C.C. (2d) 530 (Que. Sess. of Peace 1972), *affirmed*, 65 D.L.R. (3d) 443 (Que. C.A. 1974) (on merits).

386 *See supra* text accompanying notes 344-56.

387 *Cf.* Canada Business Corporations Act, s. 125; Companies Act, S.B.C. 1973, c. 18, s. 152; ALI Federal Securities Code, ss. 1603, 1703.

388 *See supra* text accompanying and following notes 3-5, 188-91.

389 Moreover, as the number of such cases would be difficult to predict, an agency could not accurately budget for them and the inevitable limitations on enforcement

liability by enabling the person who suffers harm from a violation, that is, the person with the greatest incentive, to pursue his own remedy would serve a number of useful purposes; it would provide an effective deterrent to the prohibited conduct by increasing the likelihood of both detection and the initiation of legal proceedings[390] and at the same time would deprive the offender of the fruits of his violation by enabling his victim to obtain compensation.[391] Civil liability would thus further both the deterrent and punitive purposes of the prohibition. In short, there is undeniably "a rational, functional connection between what is admittedly good and what is [likely to be] challenged"[392] and there is no principled reason to preclude Parliament from enacting such remedies where it considers them necessary to effectuate its criminal laws.[393]

Despite the clarity of the connection, however, it is far from certain that the Supreme Court would sustain such a remedial provision. Although the statements in the *Goodyear* decision and the reasons underlying *Zelensky* support it,[394] the tone of the Court's recent decisions has been restrictive albeit not technically preclusive.[395] In any event, the issue is unlikely to arise except in

resources would necessitate selection for prosecution only of cases involving significant issues of principle; *see supra* text accompanying notes 345-46.

390 A private action would not be subject to the constraints outlined *supra* in note 389.

391 *Cf.* Re Torek, 44 D.L.R. (3d) 416, 419 (Ont. H.C. 1974), quoted in R. v. Zelensky, 2 C.R. (3d) at 121; and *see supra* note 375. The punitive aspects of a compensatory action would be reinforced by the very fact of being taken to court and by any adverse publicity that accompanies it.

392 Papp v. Papp, 8 D.L.R. (3d) 389, 394 (Ont. C.A. 1969); *but see* S. Grange, *supra* note 321, at 37 (no such connection unless civil action preceded by criminal proceedings).

393 This conclusion is reinforced by the fact that the courts can and do perform their "very delicate role in maintaining the integrity of the constitutional limits imposed by the B.N.A. Act", R. v. Zelensky, 2 C.R. (3d) at 116, by determining the true character of the legislation in question; if it represents a "colourable attempt" to exceed federal jurisdiction through the creation of a criminal offence, the whole scheme will be invalid; *see supra* text accompanying notes 334-39.

Most of the commentators who have considered the question have concluded that there is no constitutional obstacle to the creation of civil remedies in aid of a valid criminal prohibition; *see e.g.* McDonald, *supra* note 321, at 225-29; *Leigh*, text accompanying notes 111-15; Hogg & Grover, *supra* note 321, at 207-09; P. Anisman at 316 n. 83; P. Hogg, *supra* note 32, at 287-88; *see also* Henderson, *Recent Development in Competition Law: The Limits of the Federal Criminal Law Power*, in Law Society of Upper Canada, Special Lectures: The Constitution and the Future of Canada 109, 130-34 (1978) (seemingly, but not clearly, of the same view); *but see e.g.* S. Grange, *supra* note 321, at 37; Finkelman, *supra* note 378, at 521-22; Alexander, *The Fate of Sterling Trusts Corp. v. Postma*, 2 Ottawa L. Rev. 441, 445 (1968).

394 *See supra* notes 373-76 and accompanying text.

395 *See e.g.* R. v. Zelensky, 2 C.R. (3d) 107, 124-25, discussed *supra* in notes 375 and 376; *see also* Ross v. Registrar of Motor Vehicles, [1975] 1 S.C.R. 5, 13 (1973). In the latter case Mr. Justice Pigeon declared in the majority opinion that "civil consequences of a criminal act are not to be considered as 'punishment' so as to bring the matter

relation to isolated non-market matters like the example just discussed, as the act as a whole is within Parliament's regulatory authority over trade and commerce and interprovincial undertakings.[396] In light of this constitutional basis and of the widespread encouragement of the commentators,[397] it would be unduly timid to omit from a federal securities law civil remedies that on a policy basis are thought necessary to the effective operation of the scheme even if they can be justified only as ancillary to criminal prohibitions. It might be advisable, however, to include them in a manner that permits them to be severed from the rest of the act in the event of an adverse decision concerning their validity.[398]

G. SEVERANCE

Although a securities law may be supported under several heads of federal power,[399] any determination of its validity will invariably depend on the manner in which it is drafted;[400] and even in the best of circumstances the outcome of constitutional adjudication is rarely susceptible of assured prediction.[401] In light of the possibility that some provisions of any act embodying a comprehensive scheme of securities regulation enacted by Parliament may be found to extend beyond its legislative powers, it is advisable to consider methods which may minimize the chances of

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within the exclusive jurisdiction of Parliament"; *id.* In the context the statement has nothing to do with Parliament's jurisdiction to enact civil remedies as an incident of criminal legislation; rather it means only that Parliament's jurisdiction to do so is not exclusive and that a provincial legislature may also do so provided a provincial aspect exists. In other words, the statement involves no more than an assertion that where legislative authority is concurrent, a provincial legislature may prescribe complementary civil consequences. That Mr. Justice Pigeon meant no more is indicated by his citation of authority; *see id.* at 13-14, *quoting* Lymburn v. Mayland, [1932] A.C. 318, 323-24 (P.C.). (Although the correct citation is included, [1975] 1 S.C.R. at 13 n. 6, the page reference in the body of the opinion is to the case as reproduced in 3 DECISIONS OF THE JUDICIAL COMMITTEE OF THE PRIVY COUNCIL RELATING TO THE BRITISH NORTH AMERICA ACT, 1867 AND THE CANADIAN CONSTITUTION: 1867-1954 31, 36 (R. Olmsted, ed. 1954).) However *see* R. v. Zelensky, 2 C.R. (3d) at 142 (*per* Pigeon, J., dissenting).

396 *See supra* ch. III.B, C; and *see supra* text accompanying notes 357-66.

397 *See supra* note 393.

398 Severability is discussed *infra* ch. III.G.

399 *See supra* ch. III.B, C, E.

400 The drafting and structure of a statute may influence its characterization and the severability of its parts; *see e.g.* A.G. Alta. v. A.G. Can., [1947] A.C. 503 (P.C.); A.G.B.C. v. A.G. Can., [1937] A.C. 377 (P.C.).

401 *See e.g.* N.S. Bd. of Censors v. McNeil, 19 N.R. 570 (S.C.C. 1978) (majority of five with four dissenting justices); Reference re Anti-Inflation Act, [1976] 2 S.C.R. 373, discussed *supra* notes 274-78 and accompanying text; and *see supra* note 290; *cf.* Laskin, *Judicial Integrity and the Supreme Court of Canada*, 12 L. SOC'Y GAZETTE 116, 118 (1978) ("if a case gets to the Supreme Court, it is by that fact alone very likely a case that may go either way").

the complete scheme being declared invalid. The most obvious technique is the inclusion in the legislation of a declaration that all of its provisions and parts are severable.

The courts have frequently dealt with the effect of an invalid provision on the remaining elements of a statute.[402] On occasion they have assumed without discussion the severability of the unconstitutional part;[403] but such cases usually illustrate a silent application of the approach articulated in the decisions that expressly consider the question of severance. When the valid provisions of a statute are not "so inextricably bound up with the part declared invalid that...[they] cannot independently survive",[404] they may be declared severable so that only the latter part of the legislation ceases to have effect.[405] A determination of severability thus necessarily involves an assessment of the scheme of the act and of the relative importance of the unauthorized and remaining provisions to the effectuation of its purpose; in other words the intellectual process, like other exercises in statute interpretation,[406] requires a determination of whether the remaining part of the legislation standing alone is sufficiently close to the intent of the act as a whole to have been enacted by Parliament in its excised form.[407] The cases in which the issue has been raised reflect an application of these principles.[408] In fact, it appears that the courts

402 *See e.g.* Lymburn v. Mayland, [1932] A.C. 318, 326–27 (P.C.); Goodyear Tire & Rubber Co. of Canada Ltd. v. R., [1956] S.C.R. 303, 310.

403 *See e.g.* Reference re Agricultural Products Marketing Act, 19 N.R. 361, 368, 423–24 (S.C.C. 1978).

404 A.G. Alta. v. A.G. Can., [1947] A.C. 503, 518 (P.C.).

405 *See generally* P. Hogg, *supra* note 32, at 88–90; Laskin, *supra* note 35, at 101.

406 *See e.g.* Interpretation Act, s. 11 ("Every enactment shall be...given such...construction and interpretation as best ensures the attainment of its objects"); *cf. Anisman* at 240–43.

407 *See e.g.* A.G. Alta. v. A.G. Can., [1947] A.C. 503, 518 (P.C.) ("whether on a fair review of the whole matter it can be assumed that the legislature would have enacted what survives without enacting the part that is *ultra vires* at all"); Reference re Section 5(a) of the Dairy Industry Act, [1949] S.C.R. 1, 45, 53–54, 67, 80–81 (1948). As with other interpretative questions, the intent of the legislation and the intention of Parliament are constructs; *cf. e.g.* Hand, *How Far is a Judge Free in Rendering a Decision?* in L. Hand, The Spirit of Liberty 79, 82 (I. Dilliard, ed. 1959); *see also* C. Howard, Australian Federal Constitutional Law 20–21 (2d ed. 1972). As a result, the process is analogous to the interpretative presumption of constitutionality; *see e.g.* B. Laskin, Canadian Constitutional Law 145–46 (rev. 3d ed. 1969); P. Hogg, *supra* note 32, at 88, 90–92 ("reading down"); and *see* Reference re Agricultural Products Marketing Act, 19 N.R. 361, 369, 429, 437 (S.C.C. 1978) (application of principle of interpretation by "reading down" scope of provisions); Di Iorio v. Warden of the Common Jail of Montréal, 73 D.L.R. (3d) 491, 524 (S.C.C. 1976) (*per* Dickson, J.); Laskin, *supra* note 401, at 119 ("in many cases, provincial legislation is not invalidated as such, but is simply limited in its application so as not to encroach upon a federal area of jurisdiction").

408 *See e.g.* Toronto v. York, [1938] A.C. 415, 427–28 (P.C.); Roy v. Plourde, [1943] S.C.R. 262, 264; Reference re Section 5(a) of the Dairy Industry Act, [1949] S.C.R. 1 (1948),

may be becoming increasingly receptive to the doctrine of severability.[409]

The inclusion in an act of a provision proclaiming the independence of the various parts and provisions of the statute and that the invalidity of any of them does not affect the continued viability of the others will not alter the analytical approach espoused in past judicial decisions as is apparent from the one case under the BNA Act in which an express clause was considered. In the *Natural Products Marketing Reference* the Privy Council, despite such a severance provision, applied the traditional test for severability, concluded that "the whole texture of the Act...[was] inextricably interwoven" so that none of the provisions could "exist independently"[410] and declared the whole act *ultra vires* Parliament. A section declaring the severability of the various parts of the act, therefore, by expressly indicating Parliament's intention, will merely create a presumption of severability, thus encouraging the courts to favour severance if they conclude that it is possible.[411] Indeed, this result has followed in the United States where the use of severance provisions is common[412] and in Australia where a similar declaration is included in the interpretation act of every jurisdiction.[413]

If a severance provision is included, it would also be advisable to draft the legislation in a manner that facilitates severability as far as possible without detracting from the substantive structure

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affirmed without consideration of this issue, [1951] A.C. 179 (P.C. 1950); N.S. Bd. of Censors v. McNeil, 19 N.R. 570, 605 (S.C.C. 1978) (severable); *In re* The Initiative and Referendum Act, [1919] A.C. 935, 944-46 (P.C.); A.G. Can. v. A.G. Ont., [1937] A.C. 355, 367 (P.C.); A.G.B.C. v. A.G. Can., [1937] A.C. 377, 388-89 (P.C.); A.G. Alta. v. A.G. Can., [1947] A.C. 503, 518-19 (P.C.) (not severable).

409 *See e.g.* N.S. Bd. of Censors v. McNeil, 19 N.R. 570 (S.C.C. 1978); Reference re Agricultural Products Marketing Act, 19 N.R. 361 (S.C.C. 1978).

410 A.G.B.C. v. A.G. Can., [1937] A.C. 377, 388-89 (P.C.). The Judicial Committee concluded that the provisions were incapable of standing alone in any event because they were ancillary to the invalid ones; *id.* at 389. The Committee stated its conclusions without detailed consideration of the severance clause, ostensibly because the lower courts had failed to discuss the issue; *id.* at 388-89. Nevertheless, the decision may be treated as one in which the structure of the statute was sufficiently integrated to preclude the operation of the section mandating severance; *see infra* text accompanying note 411.

411 The presumption is thus in effect similar to that in favour of constitutional validity; *see supra* note 407.

412 *See e.g.* Carter v. Carter Coal Co., 298 U.S. 238, 312-13, 321-22 (1936); Stern, *Separability and Separability Clauses in the Supreme Court*, 51 HARV. L. REV. 76 (1937); *see also* ALI FEDERAL SECURITIES CODE, s. 2009 (severability); and *see generally* 16 AM. JUR. 2D, *Constitutional Law*, sections 181-88 (1964).

413 *See e.g.* Bank of N.S.W. v. Commonwealth, 76 C.L.R. 1, 368-72 (1948); and *see generally* C. HOWARD, *supra* note 407, at 21-27; P. LANE, THE AUSTRALIAN FEDERAL SYSTEM WITH UNITED STATES ANALOGUES 899-910 (1972); W. WYNES, LEGISLATIVE, EXECUTIVE AND JUDICIAL POWERS IN AUSTRALIA 48-53 (4th ed. 1970).

or clarity of the act.[414] This design might be accomplished by treating the various elements of the statute in separate parts. In fact, without a constitutional motivation the proposed codification of the U.S. securities laws adopted a similar organizational approach on a functional basis.[415] A comprehensive securities act would, without some such structural principles, be unworkably complex.[416] Thus, a federal securities law might include its disclosure requirements in a single or several related parts,[417] while other parts could specify definitions and exemptions[418] and requirements applicable to self-regulatory organizations[419] and securities professionals.[420] The criminal prohibitions[421] and civil liability[422] might also be prescribed in separate parts and, of course, a part dealing with the administration and enforcement of the act itself would be required.[423]

Two of these subjects, the licensing of brokers and dealers and the antifraud provisions, demonstrate the utility of such an approach. While the former straddles the limits of Parliament's legislative authority,[424] the latter is clearly within it.[425] In the event that the licensing provisions were declared invalid, their severability would be essential to avoid their dragging the rest of the legislation with them. Conversely, as the antifraud sections are likely to replace the securities offences now in the Criminal Code,[426] they must continue in force even if the rest of the act were found to be in excess of Parliament's jurisdiction. The same considerations should apply to impermissible intraprovincial elements

414 It should not, however, be necessary to duplicate provisions in order to accomplish this purpose, for to do so would likely hinder both substance and clarity; *cf.* C. Howard, *supra* note 407, at 26 ("tendency for statutes to be drafted in minute detail and with much repetition in order to facilitate severance").

415 *See* ALI Federal Securities Code at xxiii (Code divided into 20 parts).

416 *See also e.g.* Ontario Bill 7 (23 parts, plus the initial interpretation part which is unnumbered).

417 *See e.g.* Ontario Bill 7, pts. XIII-XX; ALI Federal Securities Code, pts. IV-VI; *see generally, Grover & Baillie.*

418 *See e.g.* Ontario Bill 7, s. 1 and pts. XI, XVI; ALI Federal Securities Code, pts. II-III and s. 512; *see generally, Iacobucci.*

419 *See e.g.* Ontario Bill 7, pts. VIII-IX; ALI Federal Securities Code, pts. VIII-X; *see generally, Dey & Makuch.*

420 *See e.g.* Ontario Bill 7, pt. X; ALI Federal Securities Code, pt. VII; *see generally, Connelly.*

421 *See e.g.* Ontario Bill 7, ss. 118-20; ALI Federal Securities Code, pt. XVI; and *see generally, Leigh*, ch. II.A.

422 *See e.g.* Ontario Bill 7, pt. XXII; ALI Federal Securities Code, pt. XVII; and *see generally, Leigh*, ch. II.B.

423 *See e.g.* Ontario Bill 7, pts. I-VII and ss. 121-24; ALI Federal Securities Code, pt. XVIII; and *see generally, Howard; Leigh.*

424 *See supra* text accompanying notes 137, 203-13.

425 *See supra* ch. III.E.

426 *See supra* text accompanying note 316.

swept into the legislative scheme either in the ultimately mistaken view that they are ancillary to the valid parts or as a result of overbroad drafting.[427] In short, a severance provision and the separation of a federal law into functional divisions, while not sufficient to validate legislation beyond Parliament's jurisdiction, are useful precautionary measures for a legislative scheme that is otherwise justifiable.[428]

H. PARAMOUNTCY

A federal securities act is likely to contain provisions which overlap or are inconsistent with those in the provincial laws, especially as the statutes in all of the provinces are applicable to trades in securities any constituent element of which occurs in the enacting province[429] and as any federal legislation would likely apply to all but intraprovincial transactions.[430] Integration of the various statutory schemes may be attempted through federal-provincial negotiations directed at the enactment of complementary legislation as has generally been done in other areas of divided jurisdiction such as marketing of natural products and regulation of trucking.[431] Alternatively, Parliament may adopt its policies independently and leave the reconciliation of competing provisions to the courts as has more frequently been done in areas allocated exclusively to one or the other level of government depending upon the aspect from which they are approached,[432] for example, criminal law and regulation of the use of the highways.[433] A federal securites act would involve the application of both types of federal power[434] Although it is inconceivable that Parliament would in the present political climate enact such legislation without prior and full consultation with the provinces,[435] any such discussions will undoubtedly be influenced by past judicial treatment of federal and provincial legislation affecting the

427 *See supra* note 407 and text accompanying note 400.

428 *See supra* text accompanying note 399.

429 *See supra* text accompanying notes 41-50; and *see e.g.* Ontario Securities Act, s. 1(1)24 ("trade").

430 *See supra* ch. III.B.

431 *See e.g.* Reference re Agricultural Products Marketing Act, 19 N.R. 361 (S.C.C. 1978); Coughlin v. Ont. Highway Transport Bd., [1968] S.C.R. 569.

432 For discussion of the "aspect doctrine", *see generally* LASKIN, *supra* note 35, at 115-16; P. HOGG, *supra* note 32, at 84-85.

433 *See e.g.* O'Grady v. Sparling, [1960] S.C.R. 804; Mann v. R., [1966] S.C.R. 238.

434 *See supra* ch. III.B, C, E.

435 *See e.g.* P. TRUDEAU, *supra* note 238, at 15-17. In fact, it is understood that the proposals resulting from the Securities Market Study for which this paper is being written will serve as a basis for such discussions. *See also, Howard*, chs. VI, VII, discussing methods of federal-provincial regulatory coordination.

same subject matter. It is therefore necessary to consider the potential interaction between a comprehensive federal scheme for the regulation of the securities market and existing provincial laws in light of the doctrine of federal paramountcy.

Although the division of powers in the BNA Act seems to indicate the exclusivity of the classes of subjects allocated to the federal and provincial governments,[436] the courts soon recognized that the generality of the specified categories permits either level of government to deal with the same matter so long as it does so from its own constitutional perspective.[437] It was, therefore, inevitable that both Parliament and the provincial legislatures would sooner or later perceive and attempt to remedy the same problem and that the courts would be called upon to determine which of the two valid enactments should stand.[438] Despite the silence of the BNA Act on the point,[439] the courts held without hesitation that federal legislation is paramount and renders conflicting provincial laws inoperative to the extent of any collision.[440] Not surprisingly, however, the formulae devised to describe the doctrine's application, whether framed in terms of provincial "interference" with federal laws,[441] "repugnancy" between the provisions of two statutes,[442] the "meeting" of two pieces of otherwise valid legislation,[443] or simply of a "conflict" between them,[444] were far from precise[445] and provided little guidance in determining when the

436 *See* BNA Act, s. 91; the preamble to the section limits Parliament's general power to "Matters not...within the Classes of Subjects...assigned exclusively to the Provinces" and the concluding paragraph contains an irrebuttable presumption that any matter within a head of power specified in the section is not subject to provincial legislative jurisdiction.

437 *See e.g.* Hodge v. R., 9 A.C. 117 (P.C. 1883); A.G. Ont. v. A.G. Can., [1894] A.C. 189 (P.C.); *see also supra* note 432.

438 The problem was foreseen in the *Voluntary Assignments Reference*, *see* A.G. Ont. v. A.G. Can., [1894] A.C. at 200-01.

439 *See e.g.* Huson v. South Norwich, 24 S.C.R. 145, 149 (1895) (*per* Strong, C.J.); *see also* Laskin, *supra* note 35, at 24; P. Hogg, *supra* note 32, at 102 n. 6 (derives from initial and concluding clauses of BNA Act, s. 91); and *see supra* note 436.

440 *See e.g.* A.G. Ont. v. A.G. Can., [1896] A.C. 348, 368-69 (P.C.) (dictum); *see generally* Laskin, *Occupying the Field: Paramountcy in Penal Legislation*, 41 Can. B. Rev. 234 (1963); Lederman, *The Concurrent Operation of Federal and Provincial Laws in Canada*, in The Courts and the Canadian Constitution 200 (W. Lederman, ed. 1964); P. Hogg, *supra* note 32, ch. 6.

441 A.G. Ont. v. A.G. Can., [1894] A.C. 189, 200-01 (P.C.).

442 A.G. Ont. v. A.G. Can., [1896] A.C. 348, 366 (P.C.); *cf.* BNA Act, s. 95, which embodies the concept of "repugnancy".

443 Grand Trunk Ry. of Canada v. A.G. Can., [1907] A.C. 65, 68 (P.C. 1906); A.G. Can. v. A.G.B.C., [1930] A.C. 111, 118 (P.C. 1929).

444 *E.g.* A.G. Ont. v. A.G. Can., [1896] A.C. at 369; Montréal v. Montreal Street Ry., [1912] A.C. 333, 343 (P.C.).

445 *See also* Huson v. South Norwich, 24 S.C.R. 145, 149 (the principle of paramountcy "is necessarily implied in our constitutional act, and is to be applied whenever the federal and provincial legislatures adopt the same means to carry into effect

articulated standards were met.[446] Indeed, as such determinations necessarily affect both the nature of Canadian federalism and the regulation of the substantive field that is the subject of the legislation,[447] it may be, as was suggested by Chief Justice Duff, that a clear test applicable to all cases in which paramountcy is in issue cannot be devised.[448]

Nevertheless, some indication of the current concept of "conflict" may be derived from recent judicial decisions. During the last twenty years the Supreme Court has adopted an approach to questions of paramountcy analogous to the presumption of constitutionality.[449] In a series of cases involving penal legislation[450] relating for the most part to the use of the roads,[451] the Supreme Court of Canada emphasized the differences in the aspects from which the statutes in question were adopted[452] as well as the differences in their coverage[453] and in doing so evinced an inclina-

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distinct powers." *per* Strong, C.J.). Even the seeming clarity of this description fails to enhance the predictability of the outcome in specific instances.

446 *See e.g.* Multiple Access Ltd. v. McCutcheon, 78 D.L.R. (3d) 701, 704 (Ont. Div'l Ct. 1977), *affirmed* (Ont. C.A. June 14, 1978, unreported) ("The verbal formulae, of themselves, are too uninformative to solve paramountcy problems"); *see generally* Laskin, *supra* note 440, at 237-40.

447 *See e.g.* Laskin, *supra* note 440, at 236-37.

448 *See* Prov. Secr. P.E.I. v. Egan, [1941] S.C.R. 396, 401-02 ("I doubt if any test can be stated with accuracy in general terms for the resolution of such questions. ... It would be most unwise ... to attempt to lay down any rules for determining repugnancy").

449 *See supra* note 407; and *see e.g.* N.S. Bd. of Censors v. McNeil, 19 N.R. 570, 594 (S.C.C. 1978).

450 *See generally* Leigh, *The Criminal Law Power: A Move Towards Functional Concurrency?* 5 ALTA. L. REV. 237, 247-53 (1967); and *see supra* note 440.

451 *See* O'Grady v. Sparling, [1960] S.C.R. 804 ("reckless" and "careless" driving); Stephens v. R., [1960] S.C.R. 823 (leaving the scene of an accident); Mann v. R., [1966] S.C.R. 238 ("dangerous" and "careless" driving); Ross v. Registrar of Motor Vehicles, [1975] 1 S.C.R. 5 (1973) (suspension of driver's licence); Bell v. A.G.P.E.I., [1975] 1 S.C.R. 25 (1973) (suspension of driver's licence); *see also* Prov. Secr. P.E.I. v. Egan, [1941] S.C.R. 396 (suspension of driver's licence); and *see* Reference re Validity of Section 92(4) of the Vehicles Act, 1957 (Sask.), [1958] S.C.R. 608 (breathalyzer).

Paramountcy issues have not, however, been so limited; *see e.g.* Johnson v. A.G. Alta., [1954] S.C.R. 127, 135-39 *(per* Rand, J.) (slot machines); Smith v. R., [1960] S.C.R. 776 (false prospectus); Robinson v. Countrywide Factors Ltd., 72 D.L.R. (3d) 500 (S.C.C. 1977) (bankruptcy and insolvency: fraudulent preferences); N.S. Bd. of Censors v. McNeil, 19 N.R. 570 (S.C.C. 1978) (obscenity); *see also* Multiple Access Ltd. v. McCutcheon,78 D.L.R. (3d) 701 (Ont. Div'l Ct. 1977), *affirmed* (Ont. C.A. June 14, 1978, unreported) (insider trading).

452 *See e.g.* Smith v. R., [1960] S.C.R. at 781; and *see* Prov. Secr. P.E.I. v. Egan, [1941] S.C.R. at 402-03, *quoted with approval* in Ross v. Registrar of Motor Vehicles, [1975] 1 S.C.R. at 10.

453 *See e.g.* O'Grady v. Sparling, [1960] S.C.R. at 808-11; Stephens v. R., [1960] S.C.R. at 826-27; Mann v. R., [1966] S.C.R. at 246, 251-54; Robinson v. Countrywide Factors Ltd., 72 D.L.R. (3d) at 528, 539.

tion to uphold provincial legislation where possible.[454] Moreover, in one of the early cases involving, significantly, a prosecution under a provincial securities act for issuing a false prospectus, Mr. Justice Martland enunciated an extremely narrow definition of "conflict"[455] which has since been adopted by a majority of the Court,[456] namely, that two provisions may "operate concurrently" so long as "compliance with one [does not] involve...breach of the other".[457] The fact that the provincial and federal provisions considered in the *Smith* case were virtually identical in substance[458] led at least one commentator to conclude in effect that Mr. Justice Martland's weak test of paramountcy was the exclusive one[459] and this conclusion was reinforced by subsequent decisions of the Court.[460]

The narrow standard is not, however, the only one that has been adopted nor did any of the decisions indicate that it should be.[461] In fact, in its recent decisions the Court has been careful to interpret the provisions under consideration in a manner that avoided duplication, the standard of repugnancy adopted in its earlier decisions,[462] and has pointedly asserted that the provincial statute precluded conduct not covered by the federal prohibition.[463] Even in *Smith* the majority, albeit confusing the question of validity with standards of paramountcy,[464] stressed

454 *See supra* note 449 and accompanying text.

455 *See* Smith v. R., [1960] S.C.R. at 800.

456 *See* N.S. Bd. of Censors v. McNeil, 19 N.R. at 601. A statement by Mr. Justice Judson, writing for the majority, in O'Grady v. Sparling, [1960] S.C.R. at 811 ("Both provisions can live together and operate concurrently") may be interpreted to have the same effect; but *see infra* text accompanying notes 462-63; and *see* Multiple Access Ltd. v. McCutcheon, 78 D.L.R. (3d) at 704-05.

457 Smith v. R., [1960] S.C.R. at 800.

458 *See id.* at 784-86, 795, 801-04 (*per* Locke, Cartwright and Ritchie, JJ., respectively, dissenting).

459 *See* Laskin, *supra* note 440, at 257 (concluding *Smith* overruled Home Ins. Co. v. Lindal, [1934] 1 D.L.R. 497 (S.C.C. 1933); *see also infra* text accompanying note 462.

460 *See e.g.* Ross v. Registrar of Motor Vehicles, [1975] 1 S.C.R. 5 (1973), holding provincial legislation suspending a driver's licence not in conflict with a judicial order made pursuant to the Criminal Code, s. 238(1) that permitted the accused to drive during working hours even though the provincial statute nullified the order's effect; *see also e.g.* P. Hogg, *supra* note 32, at 106-09.

461 *See e.g.* Multiple Access Ltd. v. McCutcheon, 78 D.L.R. (3d) at 707 (statement by Martland, J. only one test and not intended "as a universal principle").

462 *See e.g.* Home Ins. Co. v. Lindal, [1934] 1 D.L.R. 497 (S.C.C. 1933) (duplicative provincial prohibition against drunk driving inoperative); *see also* Johnson v. A.G. Alta., [1954] S.C.R. 127, 135-39 (*per* Rand, J.); N.S. Bd. of Censors v. McNeil, *supra* note 451.

463 *See supra* note 453. In other words, the provincial provisions were stricter than the federal.

464 *See* Smith v. R., [1960] S.C.R. at 781 (*per* Kerwin, C.J.). Despite his assertion that "it is not the same conduct being dealt with by the two legislative bodies", *id.*, it appears that a different aspect alone was sufficient in Chief Justice Kerwin's view

the different aspects from which the two provisions were enacted, thus implying the existence of a difference between them.[465] And in the *McNeil* case in which a majority of the Court expressly adopted Mr. Justice Martland's formulation of the meaning of "conflict",[466] it applied the duplication standard and declared inoperative a Nova Scotia regulation because it was in effect identical with a provision of the Criminal Code,[467] even though the regulation could not have been brought within the narrow definition as undermining the federal law.[468] In short, it is reasonable to conclude that provincial legislation which merely duplicates existing federal prohibitions as well as legislation that is inconsistent with a federal enactment in the sense described by Mr. Justice Martland in *Smith* are subject to federal paramountcy and inoperative.[469]

Thus, although Parliament may not repeal a validly enacted provincial statute, it may displace it by passing legislation that is identical or inconsistent.[470] The possibility of federal occupation of an entire field, that is, of preemption, by this means highlights the importance of Parliament's intention, and concomitantly of the

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to permit the concurrent operation of the identical provisions; *see supra* text accompanying note 458. *See also* P. Hogg, *supra* note 32, at 111.

465 *See* [1960] S.C.R. at 781.

466 *See supra* note 456 and accompanying text.

467 *See* N.S. Bd. of Censors v. McNeil, 19 N.R. at 604. In fact, Mr. Justice Ritchie, who wrote the majority opinion in *McNeil*, has consistently adhered to the same position, namely, that duplication renders provincial legislation inoperative; *see e.g.* Smith v. R., [1960] S.C.R. at 801-04 (dissenting); O'Grady v. Sparling, [1960] S.C.R. at 822 (concurring on basis that "there is a fundamental difference between the subject-matter dealt with" in the two enactments); Stephens v. R., [1960] S.C.R. at 829 (provisions "substantially different"); Mann v. R., [1966] S.C.R. 238, 251 (everyone who violates prohibition in Criminal Code also violates provincial act "but...the converse is [not] necessarily the case"; therefore, two sections "deal with different subject matters").

468 *Cf. e.g.* Multiple Access Ltd. v. McCutcheon, 78 D.L.R. (3d) at 704 (as provisions identical, application of provincial section nullifies federal in that no liability remaining); *see also* Laskin, *supra* note 440, at 258-59 (operational inconsistency where identical schemes of distribution).

Potential double penal liability does not create a conflict between two provisions; *see e.g.* P. Hogg, *supra* note 32, at 112; and *see generally* Friedland, *Double Jeopardy and the Division of Legislative Authority in Canada*, 17 U. Toronto L.J. 66 (1967), *reprinted in* M. Friedland, Double Jeopardy 405 (1969).

469 *See e.g.* Lederman, *supra* note 440, at 213-19; Leigh, *supra* note 450, at 249; and *see* Laskin, *supra* note 440, at 262.

This conclusion is not shared by the authors, one of whom adheres to the view already expressed by him that duplication is probably not a test of inconsistency; *see* P. Hogg, *supra* note 32, at 110-11. On this view a federal securities act would have little effect on the operation of provincial securities statutes as only federal provisions which "expressly contradict" provincial provisions would give rise to questions of paramountcy and such provisions are not likely to be common; *see also infra* note 502.

470 *See e.g.* A.G. Ont. v. A.G. Can., [1896] A.C. 348, 366 (P.C.).

interpretative element, to questions of paramountcy[471] as was made abundantly clear in a number of dissenting opinions in the Supreme Court. In both *O'Grady v. Sparling*[472] and *Stephens*[473] Mr. Justice Cartwright inferred from the prohibitions in the Criminal Code, a parliamentary intention to occupy the field by establishing minimum standards for the offences in question. In other words, he held that the adoption of a particular standard of conduct, whether recklessness or a specific intent, indicated "by necessary implication" that conduct falling short of it shall not be punishable and he would on that basis have declared the parallel provincial provisions inoperative.[474] And in a more recent decision Chief Justice Laskin drew a similar inference from the fact that the federal legislation under consideration was intended to constitute "a code on the subject of bankruptcy and insolvency".[475]

Although a majority of the Court has never applied a test of paramountcy based upon negative implication to hold provincial legislation inoperative, it has also not precluded such a finding

471 *See id.* ("if the existence of such repugnancy should become matter of dispute, the controversy cannot be settled by the action either of the Dominion or of the provincial legislature, but must be submitted to the judicial tribunals of the country"); *see also supra* notes 406, 407.

472 [1960] S.C.R. 804, 812-23.

473 [1960] S.C.R. 823, 827-29.

474 *See* O'Grady v. Sparling, [1960] S.C.R. at 820-21 ("when Parliament has expressed in an Act its decision that a certain kind or degree of negligence in the operation of a motor vehicle shall be punishable as a crime...it follows that it has decided that no less culpable kind or degree of negligence in such operation shall be so punishable. By necessary implication the Act says not only what kinds or degrees of negligence shall be punishable but also what kinds or degrees shall not. ...[T]he exclusive legislative authority in relation to the criminal law...must include the power to decide what conduct shall not be punishable as a crime...as well as...what conduct shall be so punishable"); Stephens v. R., [1960] S.C.R. at 828-29 ("The whole subject-matter of the charge against the appellant has...been drawn by Parliament within the ambit of the criminal law with the effect of suspending the provincial legislative authority in relation to that subject-matter"). The former decision involved a federal provision prohibiting reckless driving and a provincial one proscribing careless and inconsiderate driving while the latter involved offences for leaving the scene of an accident, the federal one requiring a specific intent to avoid liability and the provincial one imposing an absolute duty to remain. The essential weakness in the dissenting position was that it would have resulted in a situation in which the provinces could not enact higher standards of conduct for purposes of highway safety than those in the Criminal Code so that only activities that were so dangerous as to be considered "criminal" by Parliament could be prohibited. There can be little doubt that such a solution would be unsatisfactory; *see e.g.* Laskin, *supra* note 440, at 246; and *see supra* text accompanying notes 447, 448; *cf.* the rather conceptual approach in Lederman, *supra* note 440, at 217.

475 Robinson v. Countrywide Factors Ltd., 72 D.L.R. (3d) 500, 508-14 (S.C.C. 1977); *see also* Lederman, *supra* note 440, at 208-09 ("normal to find this [negative] implication in a federal statute that could properly be construed as a complete code for the concurrent subject...[such as the] federal code of priorities" in a bankruptcy); *cf.* Laskin, *supra* note 440, at 258-59 (priority of creditor's claims necessarily involves conflict).

where Parliament's intention to occupy a legislative field is expressly asserted.[476] In fact dicta in recent majority opinions raise the possibility of such a holding even where no operational inconsistency between two legislative schemes is otherwise found to exist.[477] An express statement in a federal securities act of an intention to exhaust the field may, therefore, be sufficient to make the parallel provincial laws repugnant.[478] However, in light of the Supreme Court's manifest apprehension over the possibility of federal absorption of provincial powers as a result of a broad interpretation of the categories in section 91 of the BNA Act[479] and of its inclination to uphold provincial legislation,[480] it is questionable whether the Court would readily implement such a provision. Rather, to avoid a conflict it might attempt an interpretation that, depending on the manner in which the jurisdictional assertion is drafted, would limit the scope of the federal law's application either by defining the "exhausted" field in terms of the substantive provisions of the act or by reading the preemptive provision as a restatement of the limitations of the act's

476 *See e.g.* Reference re Validity of Section 92(4) of the Vehicles Act, 1957 (Sask.), [1958] S.C.R. 608, 613 (no intent manifested by Parliament to limit provincial power to require sample; *per* Fauteux, J.); *cf.* Laskin, *supra* note 440, at 263 ("It may be the better part of wisdom, in the interests of a flexible federalism, to require the federal Parliament to speak clearly if it seeks, as it constitutionally can demand, paramountcy for its policies").

477 *See* Ross v. Registrar of Motor Vehicles, [1975] 1 S.C.R. 5, 15-16 (1973) (*per* Pigeon, J. for majority); Robinson v. Countrywide Factors Ltd., 72 D.L.R. (3d) at 539 (*per* Beetz, J.). Both justices advert to the Australian position, namely, that the intention of the paramount legislature governs; *see generally* C. Howard, *supra* note 407, at 36-45. The American position is similar, at least within areas of exclusive federal jurisdiction; *see generally* 16 Am. Jur. 2d, *Constitutional Law*, s. 207 (1964); E. Corwin, The Constitution and What it Means Today 224-25 (13th ed. rev. by H. Chase and C. Ducat 1973).

478 Parliament has attempted to create repugnancy in a number of ways; *see e.g.* Bankruptcy Act, 1978, Bill S-11, 30th Parl., 3d Sess., s. 167 (First reading March 21, 1978) (making procedure in Bill exclusive and thus reversing result in *Robinson v. Countrywide Factors Ltd.*); *see also* Consumer and Corporate Affairs Canada, Background Papers for the Bankruptcy and Insolvency Bill (1978) 18 (undated 1978). The Indian Act expressly adopts both the repugnancy and the duplication standards and, possibly, attempts as well to occupy the complete field covered by the Act; *see* R.S.C. 1970, c. I-6, s. 88 (provincial laws of general application applicable to Indians "except to the extent that such laws make provision for any matter for which provision is made by or under this Act"); for discussion of the section *see* P. Hogg, *supra* note 32, at 388-89.

479 *See e.g.* Mann v. R., [1966] S.C.R. 238, 250 (*per* Fauteux, J.); *see also supra* text accompanying notes 288-90.

480 *See supra* text accompanying notes 450-54. It is perhaps significant that the recent statements of the presumption of constitutionality refer only to provincial legislation; *see supra* notes 407, 449. *See also* A.G. Que. v. Kellogg's Company of Canada, 19 N.R. 271, 288 (S.C.C. 1978) (unexercised power to make regulations does not raise issue of conflict).

coverage.[481] Nevertheless, uncertainty about Parliament's ability so to occupy a legislative field does not substantially impede the enactment of securities legislation, especially as wholly intra-provincial transactions will likely not be included in any event,[482] and it may strengthen a federal negotiating position in relation to the development of a cooperative regulatory scheme.[483]

The impact of a comprehensive federal scheme of securities regulation will vary with the subject matter of each part of the scheme and even within parts. For example, the interaction of the takeover bid provisions of a federal law with those in the provincial securities acts may differ between provinces[484] and may also lead to different results than a comparison of the insider reporting requirements.[485] And the conclusions concerning operational compatibility in both areas may differ from that for accountability of an insider to his issuer for profits obtained as a result of improper trading in securities.[486] Not even these statements can be made with assurance, however, for an analysis of paramountcy must be based on the drafting of the federal act.[487] Without specific legislation for comparison a discussion of the compatibility of federal and provincial regulatory legislation runs the double risk of becoming mired in a mass of hypothetical detail or of being little more than a series of vague generalizations. Nevertheless, it may be possible to avoid both dangers by focusing on the major elements common to all modern securities acts.[488]

As was said above, an essential component of a law for the regulation of the securities market is a requirement that issuers disclose information relating to the value of their securities both at the time of issue and, where a secondary market exists, on a

481 *Cf. e.g.* Laskin, *supra* note 440, at 260 (provision stating that inadvertent negligence not an offence would not have altered result in *O'Grady v. Sparling* as it "would go no farther than to determine the actual reach of the offence in the particular case"). The most direct method of preemption would be a statutory declaration that specified provincial laws are not applicable but such a provision might be treated as a colourable attempt to repeal provincial legislation; *see supra* notes 335-39 and accompanying text.

482 *See e.g. supra* text accompanying notes 196-99.

483 *See supra* note 435 and accompanying and following text; *see also* Lederman, *supra* note 440, at 219 n. 39 ("the bargaining position of federal and provincial governments is defined by the judicial decisions about concurrency and the doctrine of Dominion paramountcy").

484 For a discussion of paramountcy issues between federal and provincial takeover bid legislation, *see* P. ANISMAN at 63-65 n. 14.

485 *Cf.* Multiple Access Ltd. v. McCutcheon, 78 D.L.R. (3d) 701, 707-08 (Ont. Div'l Ct. 1977), *affirmed* (Ont. C.A. June 14, 1978, unreported) (unnecessary to decide whether provincial reporting provisions inoperative but indicates that they may be).

486 *See id*

487 *See supra* text accompanying notes 449-53.

488 These elements are described *supra* ch. III.A.

continuing basis.[489] Disclosure in connection with a distribution is made in a prospectus and the informational prescriptions are usually supplemented by a discretion in an administrator to refuse to permit the sale of the securities if specified standards are not met.[490] Continuous disclosure is made in documents such as annual and quarterly reports, proxy statements, insider reports and press releases.[491] The most common approach is to impose broad basic requirements and to create statutory and administrative exemptions[492] for situations in which the protection ordinarily afforded by the legislation is unnecessary[493] and, of course, to authorize the administrator to deny the exemptions where they are abused.[494] The majority of the provincial securities acts follow this pattern and it is indisputable that they have been validly enacted to protect local investors.[495] A federal act would undoubtedly deal with the same subject matter[496] and would likely adopt a similar approach; and it too, depending on the manner in which it is drafted, would be valid.[497]

In such circumstances the continued effectiveness of the provincial requirements would be subject to question. The issue is most difficult if the same information is required to be disclosed contemporaneously under both acts[498] for it might be argued that

489 *See supra* text accompanying notes 91-97.

490 *See supra* notes 92, 97 and accompanying text.

491 *See supra* notes 93-96 and accompanying text. Press releases are commonly used to disclose material developments; Ontario Bill 7, s. 74, would require the filing of such releases with the Commission. Although disclosure is also required in connection with takeover bids, a takeover bid circular is not part of a continuous disclosure system because it is required only in extraordinary circumstances; *see e.g.* Ontario Securities Commission Disclosure Report ¶ 2.08; P. Anisman at 206 n. 299.

492 The coverage of a broad general provision may also be limited by creating exceptions from the definitions; *see e.g.* L. Loss and E. Cowett, Blue Sky Law 352 (1958).

493 *See e.g.* Ontario Securities Act, ss. 35, 58; Ontario Bill 7, pts. XIV-XVI; and *see, Grover & Baillie*, chs. V.C., VI.D, VIII.C.

494 *See e.g.* Ontario Bill 7, s. 124; *cf.* Ontario Securities Act, s. 19(5). Not surprisingly, there are minor variations between the acts of different provinces; *see e.g.* P. Anisman at 184-96.

495 *See* Lymburn v. Mayland, [1938] A.C. 318 (P.C.); *see also supra* text accompanying notes 36-40. The pattern outlined in the text has been adopted in all of the provinces in connection with distributions and in Alberta, British Columbia, Manitoba, Ontario, Québec and Saskatchewan with respect to continuing disclosure as well.

496 A federal act would probably not be applicable to intraprovincial transactions but both it and the provincial laws would apply to interprovincial transactions as well as to the same issuers; *see supra* text accompanying notes 41-49 and ch. III.B.

497 *See supra* ch. III.B.

498 The provincial acts authorize an exemption from the proxy provisions for issuers complying with similar requirements in their home jurisdictions; *see e.g.* Ontario Securities Act, s. 104; and a similar method of coordination is available for insider reports; *e.g. id.* s. 116. Under the Ontario Bill exemptions in such circumstances are automatic; *see* Ontario Bill 7, ss. 87 (proxy circulars), 117 (insider reports if filed with the Ontario Commission). It is questionable whether this technique of avoiding

identical disclosure requirements constitute the ultimate coordination in that compliance with both sets must occur simultaneously.[499] Indeed, no operational incompatibility exists even in the sense that enforcement of one set of provisions undercuts the effectiveness of the other, for enforcement of either ensures compliance with both.[500] As a matter of policy, therefore, this type of duplication may not warrant a declaration that the provincial law is inoperative,[501] especially as the primary effect of such a holding would be a reduction of the resources available to enforce the disclosure requirements. Nevertheless, the judicial decisions seem to require it.[502]

Although the result may be the same where the discretionary standards for a refusal to accept a prospectus are identical, the policy considerations differ.[503] It may be questionable whether a province should be able to preclude a sale of securities that has been approved by a federal agency where the criteria for the provincial refusal to permit the issuer to conduct a distribution are the same as those under the federal legislation. Such a denial would undermine the federal law while not furthering any additional provincial policies, for the provincial administrator would, in effect, merely be reviewing the federal application of the identical standard.[504]

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unnecessary duplication would avert the application of the paramountcy doctrine; *but see infra* note 508.

499 *See* Lederman, *supra* note 440, at 213 ("the ultimate in harmony"); P. Hogg, *supra* note 32, at 110; *see also supra* note 498.

500 Except for the filing requirements but doubtless filing at both levels would follow an order to comply with either. *Cf.* Laskin, *supra* note 440, at 245-46 ("practical result...from the standpoint of law enforcement") (order reversed).

501 *See id.* at 262 (in cases of duplication "policy as much as, or perhaps rather than, logic must give the answer"). It is thus arguable that the different filing requirements would alone suffice to distinguish the statutes for paramountcy purposes.

502 *See e.g.* N.S. Bd. of Censors v. McNeil, 19 N.R. 570 (S.C.C. 1978); Home Ins. Co. v. Lindal, [1934] 1 D.L.R. 497 (S.C.C. 1933); *see also supra* text accompanying notes 462-68; and *cf.* Multiple Access Ltd. v. McCutcheon, 78 D.L.R. (3d) 701 (Ont. Div'l Ct. 1977), *affirmed* (Ont. C.A. June 14, 1978, unreported) (no need "to decide any paramountcy issue" concerning reporting provisions, at 707-08).

As is indicated *supra* in note 469, the authors do not share this conclusion; in Professor Hogg's view duplication alone does not render provincial law inoperative. Even if it did, trivial differences in the two laws might lead the courts to deny the existence of duplication; *see* P. Hogg, *supra* note 32, at 111; and *see e.g. supra* note 501. Thus federal and provincial disclosure requirements are unlikely to be held duplicative as they would involve different filing obligations, one presumably in Ottawa and the other in the city in which the provincial commission is located; and licensing requirements would probably be treated similarly as they would involve applications to different administrators; *see infra* text accompanying notes 509-12.

503 This issue would not arise in respect of federal corporations; *see supra* text accompanying notes 79-82a.

504 It is unlikely, however, that the standards would be identical. Even if they were, it

The problem may, however, be easily avoided in both instances. While the courts have consistently held duplicate provincial laws inoperative,[505] they have also upheld provincial laws that extended beyond parallel federal requirements.[506] Overlapping local provisions that impose additional requirements or create stricter standards have been treated as sufficiently different to prevent a conflict even where most of the cases likely to arise were covered by both the federal and provincial statutes.[507] Thus provincial disclosure provisions that "supplement" a federal act by requiring additional items of information, by limiting the exemptions granted under the latter act or by imposing stricter standards for acceptance of a prospectus or denial of exemptions would be constitutionally unaffected.[508] In sum, it is doubtful that the disclosure requirements of a federal securities law would displace those in the provincial acts unless the provinces so desired.

The application of the paramountcy doctrine to the licensing of market actors is similar.[509] Assuming the validity of both federal and provincial legislation,[510] duplicative provincial provisions would likely be inoperative[511] but the provinces could supplement the federal requirements by imposing stricter standards for the granting, suspension or denial of registration or an exemption or by narrowing the exemptions available under the federal act.[512] The stock exchanges are not, however, susceptible to the same treatment as other market actors; if Parliament has authority over them by virtue of their being interprovincial undertakings or works for Canada's general advantage, then the provinces have none.[513] Thus while the provinces might retain jurisdiction over

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might be argued that different policy goals resulting from different aspects must lead to diverse applications of a broad public interest standard; in fact, the applications themselves establish the standard in such cases; *see e.g.* K. Davis, Discretionary Justice: A Preliminary Inquiry 15-17, 38-42 (1969); Anisman, Book Review, 47 Can. B. Rev. 670, 680 (1969).

505 The obvious exception is Smith v. R., [1960] S.C.R. 776; *but see supra* text accompanying notes 464-65.

506 *See supra* notes 453, 463 and accompanying text.

507 *See e.g. supra* note 467; *cf.* P. Hogg, *supra* note 32, at 111.

508 *See e.g.* Lederman, *supra* note 440, at 210-12, 215-16. It may also be permissible for a province to require that all documents filed under the federal act also be filed with the provincial commission; *cf. e.g. supra* note 83; and *see supra* notes 501, 502.

509 *See supra* text accompanying notes 98-102.

510 There is no question about the validity of such provincial legislation concerning brokers, dealers, advisers and underwriters, *see supra* notes 37-39 and accompanying text, but federal jurisdiction is less certain; *see supra* text accompanying notes 203-13.

511 *See supra* note 502 and accompanying text.

512 *See supra* text accompanying notes 505-08.

513 This result flows from the BNA Act, s. 92(10) itself; *see supra* note 229 and accompanying text. But the conclusion would not automatically follow if Parliament's jurisdiction over the exchanges derives from subsection 91(2) of the BNA Act; *see*

exchange members, provincial regulation of the exchanges themselves would be displaced.

Conversely, it is doubtful in view of the *Smith* case that any offence created by a provincial securities act would be found repugnant to a criminal prohibition in federal legislation;[514] the false prospectus offence in the Ontario Securities Act was sustained even though there was no substantive difference between it and the Criminal Code.[515] Indeed it is fair to say that the Supreme Court accepted a conceptual difference which was no more than a reassertion of the aspects on which the validity of the provisions rested as sufficient to distinguish them.[516] It is therefore reasonable to conclude that the Court might do so again even with identical provisions. But this result too cannot be predicted with certainty.[517]

The interaction of provisions creating civil liability is still less clear. Although the *Multiple Access* decision applies only to accountability for benefits received or receivable by an insider as a result of improper trading,[518] its rationale extends to all liability for which privity is a prerequisite.[519] The basis of the Ontario court's decision was the fact that both the federal and provincial remedies dealt with the same benefit in that each created account-

• *supra* text accompanying notes 192-94; exchanges would then be in the same position as other market actors.

514 *See* Smith v. R., [1960] S.C.R. 776; *see also supra* text accompanying notes 103-06 and ch. III.E.

515 *See id.*; and *see supra* text accompanying note 458; *see also now* Ontario Securities Act, s. 137; Criminal Code, s. 358; *compare* Ontario Securities Act, R.S.O. 1950, c. 351, s. 63. The present Ontario Act presents a stronger case for concurrent operation as it embodies a stricter standard; the express requirement that a false statement be made "knowingly" has been deleted and a defence of lack of knowledge and an inability to discover the true facts in the exercise of reasonable diligence has been added; *see* Ontario Securities Act, s. 137(3).

516 *See supra* text accompanying notes 464, 465.

517 *See e.g.* N.S. Bd. of Censors v. McNeil, 19 N.R. 570 (S.C.C. 1978). The *Smith* decision, like all paramountcy cases, is easily limited to the legislation that was before the Court, especially as the provincial provision did not expressly require an intention "to induce persons...to become shareholders" as the Code did; the intention had to be inferred from the fact that a prospectus was required only when an issuer wished to sell securities to the public. But the context was pointedly described in the dissenting opinions, *see supra* note 458, and the majority did not expressly rely on this difference in drafting. Nevertheless, it is far from clear that the Court would uphold an identical provision; *see supra* text accompanying notes 462-68.

518 Multiple Access Ltd. v. McCutcheon, 78 D.L.R. (3d) 701 (Ont. Div'l Ct. 1977), *affirmed* (Ont. C.A. June 14, 1978, unreported).

519 Most commentators interpret the insider liability provisions in Canada as creating a cause of action only for a person who trades with the insider but this conclusion has been doubted; *see, Anisman* at 234-43; and *see e.g.* Ontario Securities Act, s. 113. Ontario Bill 7, s. 131, attempts to impose a clear privity requirement.

ability to the corporation in the same measure;[520] an action under the Ontario Act would have stripped away the insider's benefits and would have thus nullified the effect of the federal provision.[521] This reasoning applies equally to an action for damages against the insider, or any other defendant, if privity is a necessary element. In such circumstances only the person who traded with the insider has a cause of action and the amount of his loss would form a single fund. A successful action under the provincial act would thus destroy the federal remedy, even though furthering the latter's policy goals, and would be subject to federal paramountcy.[522]

The result would likely be the same even if the measure of damages under the provincial statute were greater. While it might be argued that an extended measure of damages supplements the federal remedy, it is doubtful that merely increasing the amount of the award would bring the provision within the cases upholding supplementary provincial legislation for all of the Supreme Court's decisions sustaining overlapping provisions do so on the basis of a stricter provincial standard of liability.[523] In other words the statutes all applied to conduct that was not covered by the federal legislation. The extension suggested above would not; rather it would only supplement the amount of damages prescribed by Parliament and might for that reason alone be in conflict with the federal section.[524] A negative implication would similarly arise if the federal act, like the *ALI Code*, creates a remedy available to the class of persons affected by improper market conduct, for example, to all persons who trade on the opposite side to an insider trading through the facilities of a stock exchange during the period of his violation whether or not in privity with him, and imposes a ceiling on the offender's potential damages.[525] In such circumstances a provincial remedy based on

520 *Compare* Ontario Securities Act, s. 113; Canada Corporations Act, s. 100.4. The coverage of the latter provision is, in fact, broader as the definition of "insider" is wider and the liability provision applies as well to employees and persons retained by the corporation; *see e.g. Anisman* at 182-84, 190-91, 207, 269-70; on accountability, *see id.* at 255-60.

521 *See* 78 D.L.R. (3d) at 704 ("For all practical purposes if a plaintiff resorts to one set of provisions to recover the loss, or benefit or advantage, then the factual subject-matter is completely and exclusively covered and there is no scope whatsoever for the other to have any operational effect").

522 *See id.* Significantly, Mr. Justice Morden included a loss by a person who trades with an insider in his discussion of constitutional principle.

523 *See supra* note 453.

524 *Cf.* Johnson v. A.G. Alta., [1954] S.C.R. 127, 138 (*per* Rand, J.). If anything may occupy a legislative field by implication, it is the measure of damages specified for the same conduct.

525 *See e.g.* ALI Federal Securities Code, ss. 1703(b), 1708(b); *see also, Anisman* at 236-43, 250-52.

privity would undercut both the amount available under the federal legislation and any prorationing requirements that follow from the specification of a maximum liability.[526] And a provincial market remedy without a similar limitation, even though, again, it might arguably "supplement" the federal scheme, would be inconsistent because it would subvert Parliament's clearly expressed intention to limit damages.[527]

The judicial reconciliation of a comprehensive federal securities law with the provincial securities acts pursuant to principles of paramountcy could thus involve a wide number of provisions and would necessitate litigation with little likelihood of satisfactory resolution.[527a] An integrated national scheme for the regulation of the securities market may, therefore, best be developed through federal-provincial negotiations utilizing the techniques of cooperative federalism devised to deal with similar regulatory issues.[528]

I. FEDERAL-PROVINCIAL INTERDELEGATION

One method of federal-provincial cooperation merits special attention. If a federal act does not apply to intraprovincial distributions,[529] the provinces will wish to retain some mechanism to ensure that local investors receive protection in such transactions like that under the present provincial securities acts or under the federal legislation. However, the maintenance of an agency to supervise intraprovincial distributions may be unduly expensive in provinces in which few are made; such provinces may prefer that the federal or another provincial body vet local prospectuses either in accordance with the standards that it usually applies or with locally established ones.[530] Conversely, the provinces with the

526 *See e.g.* ALI FEDERAL SECURITIES CODE, s. 1711.

527 *But cf.* Reference re Validity of Section 92(4) of the Vehicles Act, 1957 (Sask.), [1958] S.C.R. 608; and *see supra* text accompanying note 481.

It is also questionable whether a province could create a market remedy involving a prorationing scheme and a ceiling on liability where Parliament's remedies require privity, for the provincial scheme might then preclude a plaintiff from obtaining his full measure of damages under the federal law.

527a However, in the view of the authors the effect of a federal securities act on existing provincial legislation would be minimal; *see supra* notes 469, 502; *see also supra* text accompanying notes 507-17. Indeed it is possible that the Supreme Court's decision in *Multiple Access* will go far to resolve many of the issues raised in the text; *see supra* text accompanying notes 518-24.

528 *See supra* note 431 and accompanying text; and *see generally* P. HOGG, *supra* note 32, at 54-57.

529 *See supra* ch. III.B.

530 Prior to 1971 the smaller provincial commissions tended to rely on clearance by the larger ones of prospectuses in national issues; since April 1971 when National Policy No. 1, 2 CCH CAN. SEC. L. REP. ¶ 54-838 ("Clearance of National Issues"), became effective, this procedure has been formalized. On prospectus clearance for national issues, *see generally* Lockwood, *Procedures in Cross-Country Prospectus Clearance*

larger, more efficient commissions may wish them to continue to supervise all securities trading subject to provincial jurisdiction and the federal government may find it useful to harness the expertise existing in such commissions by establishing them as local offices for the administration of its legislation as well.[531] Cooperative regulation of the securities market may, therefore, involve not only the enactment of complementary federal and provincial legislation but also the appointment of common bodies to administer it; the latter end may be accomplished by the now common device of interdelegation.[532]

Although legislative jurisdiction cannot be delegated between Parliament and the provincial legislatures so as to extend the powers allocated to either under the BNA Act,[533] any of them may delegate authority to administer a statute validly enacted by it to an agency established by another level of government with the capacity to accept the delegation.[534] Parliament and the provincial legislatures may, therefore, delegate complementary administrative powers to the same body so that it may devise and apply consistent policies to both local and interprovincial aspects of the securities market.[535] Alternatively, either government may enact its own comprehensive scheme and delegate its administration to the one agency.[536] The delegate then acts in any specific instance on behalf of the legislature within whose jurisdiction the matter being regulated falls.

While a blanket delegation may be effective in some cases, in others it may not provide the most efficient method of regulation. A federal agency created to regulate the securities market will not displace the provincial commissions.[537] As coordination of regulatory activities may in some circumstances be accomplished better by supervision of specific elements of the market, rather than of the market as a whole, at the national or local level, it may be desirable to provide for delegation of specific parts of the various

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and Regulation by Policy Statement, in LAW SOCIETY OF UPPER CANADA, SPECIAL LECTURES 1972: CORPORATE AND SECURITIES LAW 111 (1972).

531 *See generally, Howard*, chs. VI, VII.

532 *See generally* P. HOGG, *supra* note 32, at 223-37.

533 *See* A.G.N.S. v. A.G. Can., [1951] S.C.R. 31 (1950); *see also* LASKIN, *supra* note 35, at 3. The decision is criticized in P. HOGG, *supra* note 32, at 224-25.

534 *See e.g.* P.E.I. Potato Marketing Bd. v. H.B. Willis Inc., [1952] 2 S.C.R. 392 (federal delegation to provincial board); Reference re Agricultural Products Marketing Act, 19 N.R. 361, 368-69, 425 (S.C.C. 1978) (provincial delegation to federal board; *per* Laskin, C.J., Pigeon, J., concurring on this issue).

535 *Cf. e.g.* Coughlin v. Ont. Highway Transport Bd., [1968] S.C.R. 569.

536 *See e.g.* Reference re Agricultural Products Marketing Act, 19 N.R. 361 (S.C.C. 1978); *see also, Howard*, ch. VI.

537 *See supra* ch. III.H; *see also, Howard*, ch. VII.

acts, and even of specific provisions, perhaps on an ad hoc basis. Nor need such partial delegation occur in the legislature or the cabinet. Any Canadian legislature, provincial or federal, may authorize its own agency to subdelegate the administration of various parts or provisions of its act to another equivalent body that has the capacity to accept it in order to permit flexibility of administration and enforcement.[538]

On the other hand, some provinces may wish to accept the standards of a federal act without replicating the complete statute, especially as it may be difficult to devise complementary legislation that is clearly within the authority of each legislative body.[539] The difficulties of drafting and enacting a detailed statute may be avoided by the use of both interdelegation and incorporation by reference of the law of the other jurisdiction as amended from time to time so that the delegate can apply the provisions of its own statute to all transactions in both jurisdictions.[540] This combination of techniques has been used in connection with the regulation of highway transport; after the Privy Council declared that the provinces lack jurisdiction to regulate interprovincial transportation undertakings[541] Parliament delegated its regulatory powers to the provincial boards established to supervise local transport by means of a statute that simply authorized the provincial agencies to grant licences to undertakings within federal jurisdiction "upon the like terms and conditions and in the like manner as if the extraprovincial undertaking operated in the province were a local undertaking".[542]

It is therefore open to Parliament to facilitate the maximum amount of federal-provincial cooperation. It may establish a body to administer a federal securities act that applies to matters within its jurisdiction and may at the same time either itself delegate the administration of the act or parts of it within a particular province to the securities commission administering the local act or authorize the federal agency to make the delegation as it becomes necessary or advisable. It may also empower its own agency to accept a delegation from a provincial legislature whether made directly or indirectly. In short, the availability of interdelegation

538 *See e.g.* Reference re Agricultural Products Marketing Act, 19 N.R. at 369, 439-40 (*per* Laskin, C.J., Pigeon, J., concurring).

539 *See e.g. id.*

540 Incorporation by reference has been consistently approved by the Supreme Court; *see* A.G. Ont. v. Scott, [1956] S.C.R. 137 (1955); Coughlin v. Ont. Highway Transport Bd., [1968] S.C.R. 569; R. v. Smith, [1972] S.C.R. 359 (1971); *see generally* P. Hogg, *supra* note 32, at 228-32.

541 *See* A.G. Ont. v. Winner, [1954] A.C. 541 (P.C.).

542 Motor Vehicle Transport Act, S.C. 1953-54, c. 59, s. 3(2); *see now* R.S.C. 1970, c. M-14, s. 3(2).

enhances Parliament's legislative, and therefore its negotiating, flexibility.

Chapter IV
Conclusion

The securities market performs an essential function in facilitating the transfer of funds from savers to those who may use them productively. Its efficiency as an allocative mechanism has wide ramifications; it affects industrial productivity, employment and income and thus influences the overall growth of the economy. The national character of the market's role is demonstrated not only by the demand for investment capital but also by the manner in which the securities market operates. The provincial commissions have found it necessary, for example, to cooperate in devising, implementing and enforcing policies under their acts, and the stock exchanges act jointly in devising and seeking approval of their commission rate structure and frequently do so as well with other by-laws that have a national impact. More important, the exchanges and the Investment Dealers Association of Canada are now in the process of developing a Canada-wide automated trading system which seems likely to replace the existing trading floors. These developments complement the already increasing internationalization of the securities market the potential for which has already been indicated by recent acquisitions and fraudulent schemes. The fact that the securities market thus transcends provincial and even national borders combined with the market's economic function make an increased federal involvement in its regulation inevitable.[543] The major questions are the nature of that involvement and the process through which it occurs.

Although all of the provinces have enacted securities acts that are clearly within their legislative jurisdiction, the inherent limitations on provincial powers necessitate federal legislation. As a result of the fact that all provincial authority is limited under the BNA Act by the territorial boundaries of each province, difficulties of enforcement exist in connection with interprovincial trading. As well, the ability of the provinces themselves to implement some policy goals may be impeded and on occasion some provincial commissions have been forced to accept policies with which they disagreed. Moreover, as the provinces lack the power to interfere with the internal affairs of and to prevent the raising of capital by

543 The economic functioning of the Canadian securities market and the reasons for federal regulation are discussed more fully *supra* in ch. I.

a federal corporation, the prospectus and proxy requirements of their securities acts may in some circumstances be ineffective. At the very least, therefore, a number of areas exist in which provincial jurisdiction to regulate the securities market is at best uncertain.[544]

In fact the regulation of the securities market is a matter over which there is concurrent provincial and federal legislative authority. While the provinces have power to regulate local matters, Parliament may legislate in relation to interprovincial trading. A traditional transactional analysis of the trade and commerce power would, therefore, permit federal regulation of interprovincial distributions and other interprovincial activities in securities.[545]

The trade and commerce power encompasses as well the regulation of "general trade and commerce" which has been interpreted by the Supreme Court to include matters which are "transprovincial" in nature and require the establishment of an administrative or regulatory structure for their supervision. The capital accumulation process and the trading markets that support it likely fall within this rubric as is indicated, *inter alia*, by the national character of the stock exchanges. Parliament may therefore adopt comprehensive legislation to regulate the securities market either on the basis of interprovincial trading or in reliance on the Supreme Court's recent statements of the scope of its general power over trade and commerce.[546]

An alternative foundation for jurisdiction over the stock exchanges may complement Parliament's authority over trade and commerce. When the exchanges move to a national automated trading system they will become little more than a communications network extending beyond provincial boundaries and will automatically escape provincial and fall within federal legislative jurisdiction. In fact it is arguable that the stock exchanges are already interprovincial undertakings in that their clearing and reporting functions, both essential to their operation, are conducted on an interprovincial basis. Parliament may, therefore, now have the power to regulate the exchanges and their members and will clearly have it when an automated trading system is in opera-

544 *See generally supra* ch. II.

545 *See supra* ch. III.B.1.

546 *See supra* ch. III.B.2. However, it is not clear that Parliament has legislative jurisdiction over purely intraprovincial transactions even as a matter of general trade and commerce and in any event it is reasonable that each province establish the policy for the protection of investors when only its citizens are affected; *see supra* text accompanying notes 196-99.

tion.[547] And, should it wish to put its authority beyond doubt, it may do so by declaring the exchanges work for the general advantage of Canada.[548]

Parliament thus has clear jurisdiction over interprovincial and international distributions of and trading in securities and likely over the whole of the trading market as well under its authority to regulate trade and commerce, complemented by its power over interprovincial undertakings. It may therefore enact legislation requiring disclosure by issuers both in connection with a distribution and on a continuing basis and regulating the stock exchanges and their members. Such legislation might also apply directly to intraprovincial transactions and, possibly, to market actors, if necessary to ensure its proper administration.[549] And the creation of civil remedies for violation of its requirements would be justifiable on the same basis.[550] In short, Parliament may under the trade and commerce power alone or in conjunction with its jurisdiction over interprovincial undertakings adopt a comprehensive scheme for the regulation of the securities market.

Nevertheless, as the results of constitutional adjudication can rarely be predicted with certainty, it would be advisable to draft a federal securities act in discrete parts segregating its various subject matters so that a finding that one aspect of the act is beyond federal legislative authority will not extend to the whole statute, especially as some parts of the legislation will invariably be more difficult to justify than others and as some may be based on powers other than trade and commerce.[551] A provision declaring that the various sections of the act are severable should be included in order to create a presumption in favour of severance where it is possible.[552]

The interaction of a federal securities act with the existing provincial legislation cannot be thoroughly analyzed in the absence of concrete provisions. It is, however, unlikely in the light of recent judicial applications of the paramountcy doctrine that a federal law could completely displace the provincial acts even in overlapping areas. While Parliament's jurisdiction over the exchanges as interprovincial undertakings would be plenary and while the federal act could be drafted to create some inconsistencies with its provincial counterparts, the provinces would generally be able to supplement disclosure requirements and the duties of

547 *See supra* text accompanying notes 217–29.
548 *See supra* text accompanying notes 230–38.
549 *See supra* text accompanying notes 200–13.
550 *See supra* ch. III.F.
551 *See e.g. supra* ch. III.E.
552 *See supra* ch. III.G.

market actors so that at least two regulatory regimes would remain in most circumstances.[553] The most effective approach to the development of a nationally integrated, comprehensive scheme of securities regulation for Canada, therefore, is through federal-provincial negotiations. Complementary legislation and administration may thus be devised through the customary means of cooperative federalism as it has developed in Canada, including, in appropriate circumstances, the use of interdelegation.[554] The present political climate necessitates such negotiations; it is hoped that they will provide the national regulatory mechanism that is required to enhance investor confidence in and the concomitant efficiency of the Canadian securities market.

553 *See generally supra* ch. III.H
554 *See supra* ch. III.I.

The Definition of Security for Purposes of a Securities Act

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April 1978

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Chapter I
Introduction

A. SCOPE OF SUBJECT

1. *Purpose and Rationale of a Securities Act*

The definition of a security is greatly affected by the underlying purposes and objectives of securities legislation. A discussion of the definition of a security for purposes of a securities act must, therefore, first deal with the fundamental objectives and purposes of securities legislation.

President Franklin D. Roosevelt, in commenting to the U.S. Congress on the Securities Act of 1933, succinctly stated the rationale and objective of the new securities legislation:

I should like to acknowledge the help of Philip Anisman, former director of the Corporate Research Branch of Consumer and Corporate Affairs Canada. I am greatly indebted to him for the many helpful references and materials which he sent to me and for his comments on the paper. In particular, the recommendations on the definition of security in ch. VI reflect a joint effort between Dr. Anisman and me.

I should also like to acknowledge the assistance of Mark Frawley and Corey Simpson, who prepared Appendices A, B, C and D on the scope of the provincial securities statutes. [The appendices consist, respectively, of tables listing by province (a) the various definitions of security, (b) the definitions of trade, (c) the exemptions from registration and (d) the prospectus exemptions. They are on file in the Corporate Research Branch, Consumer

"The purpose of the legislation, I suggest, is to protect the public with the least possible interference to honest business.

"This is but one step in our broad purpose of protecting investors and depositors. It should be followed by legislation relating to the better supervision of the purchase and sale of all property dealt in on exchanges, and by legislation to correct unethical and unsafe practices on the part of officers and directors of banks and other corporations.

"What we seek is a clearer understanding of the ancient truth that those who manage banks, corporations, and other agencies handling or using other people's money, are trustees acting for others."[1]

In Canada, the *Kimber Report* stated the objectives of securities legislation this way:

"While the underlying purpose of legislation governing the practices and operation of the securities market must be the protection of the investing public, it is equally true that the character of securities legislation will affect the development of financial institutions and their efficiency in performing certain economic functions. The principal economic functions of a capital market are to assure the optimum allocation of financial resources in the economy, to permit maximum mobility and transferability of those resources, and to provide facilities for a continuing valuation of financial assets....

"1.10 Securities legislation must be designed not only to serve the purpose of reducing the imperfections in the free and open capital market, but also to assure the efficient operation of the market in achieving long-run economic objectives. There is also an ever present danger that in removing one imperfection, another may be created....

"1.17 The Committee believes that changes in securities legislation in the Province of Ontario should be devised in recognition of two basic propositions. To the extent that securities legislation is improved in the interest of investors, the securities industry will benefit from increased public confidence. To the extent that the industry becomes a more effective and efficient part of the economy, the general public will benefit. Both objectives

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and Corporate Affairs Canada, and will be made available on request. For a similar tabulation as of 1966 *see* J. WILLIAMSON, SUPP. at 435-506.]

1 *Cited in* 1 L. LOSS at 127.

> will be met by raising the standards governing the industry to the level presently maintained by the responsible members of the securities industry and what should be maintained, as a requirement of law, in the public interest. In this context, the Committee points out that the substantial majority of its recommendations contained in this Report deal directly or indirectly with disclosure of information to investors, that is to say, with the factor of public confidence."[2]

It is beyond the scope of this paper to discuss in detail the various methods and approaches used to achieve the purposes of securities regulations.[3] It is sufficient to mention briefly what the traditional approaches have been both in the U.S. and Canadian legislation. One approach has been the designation of fraudulent practices in the legislation together with corresponding civil and criminal sanctions for engaging in such practices. A second major approach is that of licensing people in the securities industry with the objective of ensuring that honest people are involved in securities activities. The licensing of securities participants has been subject to standards aimed at obtaining honest persons of high integrity. The third approach deals with disclosure of information relating to the securities, both at the time of the original issue of the securities and on a regular basis thereafter. The fourth approach has involved "blue skying"– that is, examination of the proposed security by the regulatory agency to determine the economic viability of the security and underlying enterprise before allowing the issue to be offered to the public. Underlying these approaches is the basic concept of a security, which is vital to the whole structure of regulation.

2. *Importance of the Definition of a Security*

The definition of a security is of obvious importance, since it will determine the scope and application of a securities act. The definition has to be designed to tie in with the other basic elements involved in securities transactions such as trading or issuing securities and distributions to specified persons or the public.

Several factors which strongly influence the definition of a security must be considered in drafting a definition for a securities statute. First, the definition must be drawn so as to achieve the

2 Kimber Report ¶¶ 1.06, 1.10 and 1.17.

3 *See generally* J. Williamson at 3-46; D. Johnston at 1-15. For recent developments, *see also* Baillie, *Securities Regulation in the 'Seventies*, in 2 Studies in Canadian Company Law 343 (J. Ziegel ed. 1973); Emerson, *An Integrated Disclosure System for Ontario Securities Legislation*, *id.* at 400.

objectives and purposes of the statute. In this context, the purpose and rationale of securities legislation from President Roosevelt's introductory statement, and from the statements of the *Kimber Report*, are aimed at protecting the public from false and manipulative or otherwise unlawful practices. At the same time, it should be remembered that securities are intangible interests and, as such, necessitate a requirement of full disclosure relating to such interests. Consequently, the definition of a security should be tied in with the regime of regulation that relates to securities generally. If the definition is not sufficiently wide to catch what are thought to be securities, then obviously the objectives of the statute will not be attained.

Although the definition should be sufficiently wide to catch the traditional and innovative forms of securities that entrepreneurs can create, at the same time one must balance the flexibility of the definition with some appreciation of certainty. One can argue that under present definitions it is difficult (especially looking at the United States) to predict what the ultimate holding of a court would be on the basic question of whether or not the instrument or interest was a security and therefore covered by the securities legislation. Though some people might argue that this uncertainty is indeed healthful or inevitable since it creates a more cautious or conservative conduct on the part of those who wish to comply with the law, there are also those who would argue that the uncertainty creates sufficient doubts and hesitancies which are not only wrong in principle but also a disincentive to business activity. At the same time, one cannot discount the costs of compliance with the securities legislation. Transaction costs involved in complying with securities legislation are not insignificant. To cast the net of the definition too widely may catch too many activities which could be rendered uneconomic or otherwise unprofitable and introduce a disrupting factor which does not achieve the economic end of the individuals who created the enterprise or venture.

The other general factor that is relevant here is the avoidance of over-regulation or unnecessary duplication. This is again dramatized quite vividly in the United States where more than one agency has taken jurisdiction over certain types of interests, thereby creating unnecessary duplication and resulting in increased costs to those who are caught by the jurisdictions of the agencies.

As in other federal countries, Canada in its commercial legislation must be mindful of uniformity. It may decide, as a federal unit, to have diversity within the federal structure, but there are strong pulls for uniformity; and indeed this has been already

recognized in corporate legislation of which securities legislation is a part.[4] However, there is another dimension to uniformity on this question, because it is inconceivable that Canada could have a definition of security which radically departs from that of the United States. As it is fairly easy to observe, the marketplace for securities is to a large extent an international one; even though many would try to argue that regulation should be national or provincial or state, as the case may be, it is nonetheless the fact that securities do cross borders with considerable ease. Consequently, it makes much sense to ensure that the definition of security is not substantially out of line with, or different from, that existing in other jurisdictions within Canada and with the principal definitions in the jurisdictions within the United States. These comments are equally applicable to legislative definitions of security and to judicial and administrative interpretations of the term since those interpretations ultimately determine the boundaries of the definition.

B. SCOPE OF THIS STUDY

This study will review Canadian treatment of the definition of security by examining the definitions found in the various provincial statutes and also in U.S. legislation. The U.S. legislation will be examined first, primarily because many of the concepts were developed there and the United States has produced much more jurisprudence and commentary on the definition of security. Some of this jurisprudence has been seeping into the Canadian administrative and judicial decisions on the subject.

There are several concepts of security or interests similar to securities that involve other regulatory agencies such as commodity exchanges and housing authorities, and there will not be a detailed treatment of these agencies or regulatory bodies in this study. Reference will be made to them at various points, but there is no space to discuss them in detail. Also excluded from detailed discussion are the requirements of prospectus and continuing disclosure treatment, the sanctions for the anti-fraud provisions, and indeed sanctions generally in relation to securities. These all could be discussed in this study, since they bear directly on the definition of security; but again, because of space limitations they will not be discussed in any detail. However, it should be remembered that security is not defined in a vacuum, since it really must be defined so as to relate to the prospectus requirements or the

4 *See e.g.* Canada Business Corporations Act, s. 4 (uniformity declared an objective of the act).

anti-fraud provisions or the sanctions that are provided in the securities statute generally.

The emphasis in the paper will be on the definition of "security" and not on the definitions of "trade" or "distribution" or "public". These latter definitions, since they represent the basic triggering events in securities transactions, are extremely important. But it is correct to say that, with the exception of the "public" concept, they have not given rise to as much controversy as that surrounding "security".

Chapter II
Scope of United States Securities Legislation

A. INTRODUCTION AND BACKGROUND OF U.S. LEGISLATION

It is interesting that, although the United States entered the securities legislation field after the United Kingdom, the U.S. legislation has become much more sophisticated and developed than that of the U.K. or Commonwealth countries. Yet, surprisingly, the sophisticated legislation has still not provided a clearly accepted definition of a security for purposes of the legislation. In fact, one commentator has stated that the United States is in the same position on this definition as it is with obscenity: the Supreme Court can generally tell a security when it sees one on a case-by-case basis, but has been unwilling to give a generic definition of the term.[5]

In the United States, the states were the first to introduce securities legislation, with the Kansas statute in 1911, containing its famous "blue sky" approach. In a period of two years, some twenty-three other states adopted securities acts based on the Kansas model.[6] It is interesting that the Kansas statute did not contain an elaborate definition of a security, since section 1 of the act simply provided that investment companies could not sell "any stocks, bonds, or other securities of any kind or character" without first registering them.[7] Thus, at the outset, the securities acts basically assumed that the definition of security was widely known and well understood, but as time went on the state statutes added various enumerative or illustrative definitions of securities.

5 Long, *Interpreting the Statutory Definition of a Security: Some Pragmatic Considerations, Introduction*, 6 ST. MARY'S L.J. 96 (1974).

6 As pointed out by Long, *id.*, it is misleading to refer to early statutes as securities acts because they were actually statutes dealing with the issuance of securities by investment companies. He states that the first true securities act (in the sense that it attempted to regulate securities rather than the company issuing them) was the Illinois Securities Act of 1919.

7 1911 Kan. Sess. Laws, c. 133, s. 1.

The basic change in the definition was made in the Illinois Securities Act of 1919, which provided that the word "securities" was to include "stocks, bonds, debentures, notes, participation certificates, certificates of shares or interest, preorganizational certificates and subscription certificates evidencing shares in trust estates or associations, and profit-sharing certificates".[8] The Illinois statute's approach to the definition provided the pattern that other legislatures were to follow. The definition in the Illinois statute contained a series of items having a fixed or generally recognized meaning, such as stocks, bonds, and debentures, followed by specific terms, and then followed by a series of general terms having no fixed or legal meaning, such as profit-sharing certificates and evidences of indebtedness, which were included in order to cover unusual or irregular forms of securities. Through the 1920s, as other irregular investment forms appeared, state legislatures added other general terms in hopes of filling in the gaps.[9]

In 1933, Congress borrowed from the earlier definitions of security in the blue sky laws in passing the Securities Act of 1933. The final definition was drafted "in sufficiently broad and general terms so as to include within the definition the many types of instruments that, in a commercial world, fall within the ordinary concept of security".[10] Congress reviewed the existing state definitions and combined most of the general terms into the single definition that is found in section 1 of the 1933 act. The 1933 act in turn became the model for the definition of security in the Uniform Securities Act, which has been adopted in one form or another in some thirty states.[11]

B. THE MAJOR SEC STATUTES

Each of the main U.S. federal securities statutes contains a definition of security and it might be useful to describe, albeit briefly, some of the major features of the federal legislation prior to dealing specifically with the definitions therein.[12]

8 Long, *supra* note 5, at 97.

9 As mentioned by Long, *supra* note 5, the Minnesota Act of 1919 added the oft-interpreted "investment contract" category and in 1923 Missouri added "certificate of interest in an oil, gas, or mining lease" and "beneficial interest in or title to property or profits".

10 H.R. Rep. No. 85, 73d Cong., 1st Sess. 11 (1933).

11 Hannan & Thomas, *The Importance of Economic Reality and Risk in Defining Federal Securities*, 25 Hastings L.J. 219, 220 n. 6 (1974); Long, *supra* note 5, at 98.

12 On the background leading to the U.S. legislation, *see generally* 1 L. Loss at 1-128. The discussion on the U.S. statutes in this paper is based on Professor Loss's work; *id.* at 129ff.

The Securities Act of 1933 was the first in the series of securities statutes passed by Congress, and it deals principally with the initial distribution of securities. Securities issued through the mails or interstate commerce must be registered by the issuer with the Securities and Exchange Commission (SEC), which was created and made responsible for administering the 1933 act by the Securities Exchange Act of 1934. The registration is done through the registration statement which must contain prescribed information about the security issuer and the underwriters. The commission, in reviewing the registration statement, does not have any authority to approve or pass on the merits of any security. The commission's only responsibility is to ensure that the security has met the standards of accuracy and completeness described by legislation. The act imposes civil and criminal liabilities for material misstatements or omissions in the registration statement or prospectus. There are also anti-fraud provisions in the statute which are enforced by injunctive and criminal sanctions. The act also specifies securities and transactions exempt from the registration and prospectus requirements but not from the anti-fraud provisions.

The Securities Exchange Act of 1934 primarily deals with post-issuance or distribution trading in securities. Its four basic purposes are to afford a measure of disclosure to people who buy and sell securities; to prevent, and afford remedies for, fraud in securities trading and manipulation of markets; to regulate the securities markets; and to control the amount of credit which goes into those markets. Through this statute, the stock exchanges and various practices of the exchanges are regulated in a variety of ways. In addition, the whole proxy machinery and related rules and practices are subject to SEC control through the rules and regulations of the Securities Exchange Act of 1934. Also under this statute, there are general provisions dealing with fraud and manipulation with respect to which the SEC has exercised a considerable amount of rule-making authority.

The Public Utility Holding Company Act of 1935 is also administered by the SEC. Basically, the act is aimed at dealing with the geographical integration and corporate simplification requirements relating to utilities; it also contains a number of regulations on the financing and operations of utility holding company systems which were deemed desirable because of alleged abuse. Whereas the theme of the Securities Act of 1933 was full disclosure of material information relating to issuers and the securities they were offering, the 1935 act goes beyond the theme of disclosure and is basically a regulatory act for a particular industry.

The Trust Indenture Act of 1939 resulted from the SEC's

conclusion that it was important to provide that trustees under indentures should be independent and active enough to protect and enforce the rights of holders of securities issued under such indentures. The procedures under the act are melded with the registration procedure under the 1933 act. The indenture must be qualified by the SEC before securities can be issued thereunder. The indenture must contain provisions which relate to certain qualifications of the trustee in terms of independence and particular forms of conduct.

Like the Holding Company Act, the Investment Company Act of 1940 is regulatory, applying to investment companies or investment trusts which are primarily involved in investing and reinvesting in securities of other companies. Registration of all investment companies as defined is required and information similar to those statements filed under the 1933 act is also required. The regulatory provisions are aimed at dealing with selling practices of investment companies as well as relating to honest and unbiased management, greater participation in management by security holders, adequate and feasible capital structures, and financial provisions for transmission of financial statements and accounting rules.[13]

The federal statutes are not intended to override the state legislation and indeed nearly all of the statutes have clauses reserving the jurisdiction of the state securities commissions.[14]

C. STATUTORY DEFINITIONS OF SECURITY IN U.S. LEGISLATION

1. *Introduction*

The security definition in the Securities Act of 1933 was the basis for subsequent definitions of security in the other federal statutes. The 1933 act defined securities as follows:

> "When used in the sub-chapter, unless the context otherwise requires – the term 'security' means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral trust certificate, pre-organization certificate or subscription, transferable share, investment contract, voting trust certificate, certificate of deposit for security, fractional undivided interest in

13 The SEC also plays a role with respect to the Investment Advisers Act of 1940 and ch. 10 of the Bankruptcy Act; *id.* at 154. Recent related federal statutes are the Securities Investor Protection Act of 1970 and the Interstate Land Sales Full Disclosure Act; *see* note 43 *infra*.

14 1 L. Loss at 156 nn. 89, 90.

> oil, gas, or other mineral right, or, in general, any interest or instrument commonly known as a 'security', or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase any of the foregoing."

The same definition is in the Investment Company Act of 1940 and the Investment Advisers Act of 1940, but the definition in the Securities Exchange Act of 1934 is slightly different.[15]

Briefly, the differences between the definitions in the 1933 and 1934 statutes are as follows: In the 1933 act, evidence of indebtedness is included as a security, whereas it is omitted from the 1934 act. In the 1934 act, the certificate of interest or participation is extended to any oil, gas, or other mineral royalty or lease, whereas in the 1933 act this type of security is expressed in terms of a fractional, undivided interest in oil, gas, or other mineral rights. In the Securities Exchange Act of 1934, there is a reference expressly excluding currency, or any note, draft, bill of exchange, or banker's acceptance, which has a maturity at the time of issuance not exceeding nine months, exclusive of days of grace or any renewal thereof, the maturity of which is likewise limited. Finally, in the 1933 act, the words "or in general any *interest* or instrument commonly known as a security" are included and a *guarantee* is expressly mentioned, but both the emphasized words are omitted from the 1934 act.

The Public Utility Holding Act definition of securities is similar to the Securities Exchange Act of 1934 definition, but it adds the terms "draft", "receivers' or trustees' certificates", "guarantee of" and "assumption of liability on...any of the foregoing". The Trust Indenture Act has a more restrictive definition of the term security, since it is used for a limited purpose in connection with the disqualification of a trustee under a trust indenture.[16]

It is arguable that, because there is the difference in the definition among the various federal statutes, there is reason to interpret security differently depending on which statute is being considered. In this connection, Professor Alan Bromberg states that:

> "Full equivalence of the 1933 and 1934 definitions does not necessarily follow. There is some reason to interpret 'security' more broadly for anti-fraud purposes (now pri-

15 Hannan & Thomas, *supra* note 11, at 221 nn. 10, 11.
16 *Id.* at 221 nn. 8, 9.

> marily a 1934 Act matter) than for registration purposes (primarily a 1933 Act matter)."[17]

He goes on to say that it is easier to justify a remedy for an investor who has been defrauded in a borderline security transaction than to give him an automatic remedy under the Securities Act of 1933 because the security was not registered under the 1933 act.[18]

At the same time, there has not been absolute consistency of treatment of the definition of a security among the state securities acts. As stated above, the Kansas statute did not introduce a special definition of security. In 1913, the California statute provided that the term was to include "stock, stock certificate, bonds, and other evidences of indebtedness, other than promissory notes not offered to the public by the maker thereof, of an investment company". It really was the Illinois Securities Act which provided the first substantial amendments to the definition of a security and the Minnesota Act of 1919 added the category of investment contract which has been the subject of so much litigation.[19]

Several of the state statutes have adopted a rather broad view of securities by including items not normally accepted to be securities. For example, Oklahoma and Wisconsin have specifically included commodity futures contracts within the definition, and Florida, Louisiana and New Hampshire have extended coverage to investments in all types of warehouse receipts.[20] Some states have had provisions covering different types of interest in real property located outside the state; and other states have enacted very broad, general provisions, such as Ohio which has stated that security means "any certificate or instrument representing title to or interest in...the capital, assets, profits, property, or credit of any person or any public governmental body".[21]

Although there are differences in the definitions among the various statutes in the United States, the federal statutes and the number of decisions interpreting the provisions have taken the dominant role in the development of securities legislation generally. On the whole, many of the decisions interpreting the federal statutes have been accepted by many state courts, although there are noticeable differences and exceptions.[21a] Although, as previously mentioned, the definitions of security in the federal statutes are not identical, the definition of the 1933 act has been a model for

17 1 A. Bromberg, Securities Law: Fraud – SEC Rule 10b-5 at 82.2 (1971).
18 *Id.*
19 Long, *supra* note 5, at 103.
20 *Id.* at 104 nn. 37, 38.
21 *Id.* at 104 nn. 39, 40.
21a *See* ch. IV *infra.*

state jurisdictions and does provide a useful starting point for looking at the U.S. legislation more closely.

2. *Specific Ingredients of the Definition of Security in the Securities Act of 1933*

a. *Introduction*

The terms "stock", "treasury stock", "bond" and "debenture", which appear in the Securities Act of 1933 as well as the other major federal statutes, are reasonably precise and have not for the most part created confusion in interpretation.[22]

It is interesting to note that several phrases found in state definitions are absent from the definition in the 1933 act. The omitted phrases are "beneficial interest in or title to property or profits" and "interests in foreign real estate".[23] With the difference in wording between the state and federal legislation, it is no wonder that Professor L. Loss states that caution must be used for two reasons:

> "Often there are slight but potentially significant variations in the wording of the particular phrase of the definition relied upon. And a case may also be distinguishable because of the presence of some other and broader phrase in the particular statute than that which is common between the two cases."[24]

The definition of a security in section 2(1) of the Securities Act of 1933 combines specific examples of securities with catch-all or general classifications within the definition. Some specific securities, such as certificates of interest in any profit-sharing agreements, are not easy to define.[25] Other specific types of securities mentioned are collateral trust certificates, preorganization certificates, transferable shares, voting trust certificates, certificates of deposit (for security receipts), and interests in oil or gas or other rights. The general classifications that are mentioned are investment contracts, any interest or instrument commonly known as a security, and any certificate or interest or participation in, tem-

22 However, as has been pointed out, "stock" and "bond" have no fixed meaning generally; 1 L. Loss at 455 n.1.

23 Apparently, the original enactment of the 1933 act included "a certificate of interest in property, tangible or intangible" but was removed as being too broad and uncertain; Long, *supra* note 5, at 98 n. 11.

24 1 L. Loss at 456.

25 As has been noted, interests in profit-sharing agreements do not have a fixed meaning and there has been some tendency to treat the term interchangeably with investment contract but recent rulings indicate an attempt to distinguish the terms; Long, *supra* note 5, at 97 n. 5.

porary certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase any of the foregoing.

In most cases, well-accepted meanings of securities are involved. However, there have been a considerable number of transactions involving securities not commonly recognized as such, and these transactions have tested the definitions in federal legislation. The specific terms have not been precisely defined either, but for the most part have not caused much confusion in terms of their technical meaning or the precise limits of their boundaries of coverage. The general terms have been tested several times and most particularly the term "investment contract" has given rise to a vast amount of litigation which will be discussed below. In looking at the definition of security, it is also important to keep the definitions of "sale" and "offer" in mind since those acts are directly related to the scope of the definition of security and of the securities statutes themselves. Finally, the exempt securities and transactions are also relevant and should be mentioned briefly.

b. *Definition of Sale and Offer*

Section 2(3) of the Securities Act of 1933 defines "sale" or "sell" to include every contract of sale or disposition of a security, or interest in a security, for value; and "offer to sell", "offer for sale" or "offer" to include every attempt or offer to dispose of, or solicitation of an offer to buy, a security, or interest in a security, for value. Several comments of interest and importance are worth making about these definitions. First, they use the word "include" rather than "means", so that the definitions of these terms are not exhaustive and are more unrestricted than the other definitions in the 1933 act which use the term "means". Second, the definitions are very broadly drawn. Third, the definitions contemplate value as an essential ingredient. Presumably, value is the same as consideration; indeed, it has been stated that no attempt has been made to distinguish between value and consideration.[26]

Because of the broadly drawn definitions, over the years questions have arisen as to the effect of exchanges, gifts, and pledges of securities, and loans in connection with securities. As a result, a complex set of rules and regulations has been promulgated by the SEC defining what the terms "sale" and "offer" mean and providing specific examples of transactions that would not be treated as a sale or an offer.[27]

One type of transaction is interesting because it raises the

26 1 L. Loss at 513.
27 *Id.*

question of interpreting both the definition of "sale" or "offer" and the definition of "security". The transaction relates to the giving of a promissory note in exchange for loans, or where goods are sold and the purchaser gives a promissory note in exchange for the goods. The questions arise as to whether or not the promissory note is a security under the 1933 act and whether or not there has been a sale of a security.[27a] Dealing with the latter question first, one can argue that the note did not involve any sale of a security since the note is simply evidence of the underlying obligation to pay, and was really not sold by the purchaser to the vendor of the goods. With respect to promissory notes as securities, this question is dealt with below in Chapter IV dealing with the types of securities adjudicated upon by the courts and administrative agencies.

It should be noted that there are other definitions in the Securities Act of 1933 which are highly relevant to the scope of the legislation. These are the basic definitions relating to "underwriter", "dealer" and "issuer".[28]

c. *Exemptions: Securities and Transactions*

i. *Exempt Securities*

Section 3 of the Securities Act of 1933 lists the securities which are exempt from the registration and prospectus requirements of the act. Section 3(a)(1) exempts transitional securities or securities which were in pre-1933 offerings. Securities of public authorities and banks are exempt under section 3(a)(2).[29] Short-term notes are exempted by section 3(a)(3) which provides that any note, draft, bill of exchange or banker's acceptance which has been or is to be used for current transactions, and which has a maturity at the time of issuance not exceeding nine months exclusive of days of grace, or any renewal thereof, the maturity of which is likewise limited, is specifically exempted. There are two conditions for exemption: the current transaction aspect, and a maturity not greater than nine months.

Securities of nonprofit issuers are exempted by section 3(a)(4) which provides that any security issued by a person organized and operated exclusively for religious, educational, benevolent, fraternal, charitable or reformatory purposes and not for pecuniary profit, and no part of the earnings of which enures to the benefit

27a *Id.* at 546 n. 289. The example given in the text arises in situations where a plaintiff is seeking redress under the anti-fraud provisions of the 1933 act (ss. 12, 17) or the 1934 act (s. 10(b) and Rule 10b-5). *See also* text accompanying note 304 *infra*.

28 For a discussion of these terms, *see* 1 L. Loss at 551.

29 *Id.* at 562-66.

of any person, private stockholder, or individual, is exempt.[30] The securities of a savings and loan or building and loan association and other institutions supervised by state or federal authorities are exempted by section 3(a)(5). In addition, securities issued by certain farmers' cooperative associations are also exempt.[31] Section 3(a)(6) exempts any security issued by a common or contract carrier, the issuance of which is subject to certain provisions of the Interstate Commerce Act. Section 3(a)(7) exempts certificates issued by a receiver or by a trustee in bankruptcy with the approval of the court. Although section 3(a)(8) exempts insurance and endowment policies and annuity contracts of corporations otherwise regulated by state or federal insurance or bank commissioners or agencies, no exemption exists for stocks or shares or other securities of insurance companies.

Section 3(a)(9) exempts any security exchanged by the issuer with its existing securityholders exclusively where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange. The exemption requires that the issuer of both securities must be the same, that (under administrative interpretation) no part of the offering may be made to persons other than existing securityholders, or even to existing securityholders otherwise than by way of exchange, and that there must be no paid solicitation.[32]

Section 3(a)(10) exempts certain securities issued in exchange pursuant to reorganizations which have been approved by a court, or by any official agency of the United States, or by any state or territorial banking or insurance commission, or other governmental authority, expressly authorized by law to grant the approval. These primarily relate to security reorganizations and transactions which are required to be approved by governmental agencies.[33]

Section 3(a)(11) exempts securities forming part of an issue offered and sold only to persons resident within a state or territory, where the issuer of the security is a person resident and doing business within, or a corporation incorporated by and doing business within, such state or territory.[34]

30 *Id.* at 468. *See* Note, 51 GEO. L.J. 855 (1963).

31 It has been pointed out that the scope of this exemption was influenced by "obvious political reasons"; *see* Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 39 (1959), *cited in* 1 L. Loss at 569 n. 34.

32 These conditions and the exemption generally are discussed in 1 L. Loss at 573–84. Loss points out that the philosophy of the exemption is not easy to understand in the light of the skepticism concerning voluntary reorganizations as reflected in the legislative history; *id.* at 573.

33 *Id.* at 584–91.

34 For a discussion of the elements of the exemption *see id.* at 591–605.

An important exemption is the power given to the commission in section 3(b) to create exemptions by its rule-making authority. The original enactment of the section stated that the commission could, from time to time, by its rules and regulations subject to such terms and conditions as may be prescribed therein, add any class of securities to the securities exempted as provided in section 3, if it finds that the enforcement of the statute with respect to the securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offerings; but no issue of securities was to be exempted where the aggregate amount at which such issue is offered to the public exceeds $100,000. The $100,000 figure was changed by a 1945 amendment to $300,000 and this in turn was changed in 1970 to $500,000. There has been a considerable amount of development relating to this section and the debate continues on the advisability of the general rule-making power and the conditions under which the SEC has exercised the power.[35]

Section 3(c) was added to the Securities Act of 1933 in 1958 by the Small Business Investment Act to empower the SEC to add to securities exempted from the Securities Act those which are issued by a small business investment company under the Small Business Investment Act of 1958 if the SEC finds, having regard to the purpose of the act, that the enforcement of the Securities Act with respect to such securities is not necessary in the public interest and for the protection of investors.[36]

The above-described exempt securities are noteworthy in that some of them indicate nothing peculiar or distinctive about the securities which warrant their exemption; and many of the exempt securities are more like transactions that could be held exempt.[37] It is also important to note that the exempt securities in section 3 – and indeed the exempt transactions in section 4 – do not extend to the fraud provisions of section 17 or section 12 relating to civil liability for sale of securities by misleading statements or omissions. Thus a basic approach of the act is to exempt certain securities where the protection of the Securities Act of 1933 is not required or where to require registration would be a hindrance to

35 *Id.* at 605-39.

36 *Id.* at 640-41.

37 The exemptions in ¶¶ 2 through 8 inclusive of the Securities Act of 1933, s. 3(a), have been described as genuine security exemptions but those in ¶¶1, 9, 10, 11 of s. 3(a) and ss. 3(b) and 3(c) have nothing that make the securities mentioned therein peculiar. In fact, it has been pointed out that the exemptions created therein were recognized because of the circumstances surrounding the particular offering; *id.* at 708-09.

the issuer. Examples of these are exemptions relating to government securities and the "small" issues, respectively.

ii. *Exempt Transactions*

Section 4 exempts certain transactions from the registration provisions of the act. The first part of section 4(1) exempts any transactions by any person other than an issuer, underwriter or dealer. Because of the definitions of issuer, underwriter or dealer contained in the act, the main effect of this exemption is to allow persons who are not "control persons" to distribute the securities without having to file a registration statement.[38] Section 4(2) exempts "transactions by an issuer not involving any public offering". This exemption has been the subject of considerable interpretation and comment.[39] Although the legislative history relating to the exemption is not that explicit, it has been pointed out that in the discussion of the exemption it was stated that the exemption permitted an issuer to make an "isolated sale" to a particular person and that the exemptions generally were directed to transactions where there was no practical need for the application of the act or where the benefits to the public were too remote.[40] It is beyond the scope of this paper to discuss in any detail the courts' and the SEC's interpretations of this exemption. It is interesting that the broadly stated exemption has undergone detailed analysis which has led to rules, opinions and commentary on the meaning and scope of the exemption.

Section 4(3) exempts dealers' transactions but with several exceptions which relate to the periods within which dealers in securities cannot transact unless they comply with the prospectus provisions.[41]

Section 4(4) exempts "brokers' transactions, executed upon customers' orders on any exchange or in the over-the-counter market, but not the solicitation of such orders". The purpose of the exemption was explained as follows:

> "Paragraph 2 [now 4] exempts the ordinary brokerage transaction. Individuals may thus dispose of their securities according to the method which is now customary without any restrictions imposed either upon the individual or the broker. This exemption also assures an open market for securities at all times, even though a stop order against further distribution of such securities may

38 *Id.* at 641-53.

39 *Id.* at 653-97.

40 H. R. Rep. No. 85, 73d Cong., 1st Sess. 5, 7, 15-16 (1933), *cited in* 1 L. Loss at 653 n. 43.

41 1 L. Loss at 256-59.

> have been entered. Purchasers, provided they are not dealers, may thus in the event that a stop order has been entered, cut their losses immediately, if there are losses, by disposing of the securities. On the other hand, the entry of a stop order prevents any further distribution of the security."[42]

By one of the Securities Reform Act of 1975 amendments, discussed below in chapter II, D.3, section 4(5) exempts promissory notes secured by a first lien on real estate which originate through banks or mortgagees approved by the Secretary of Housing and Urban Development. The exemption from the registration and prospectus requirements is apparently designed to enhance the development of a secondary market for mortgage securities to be sold to large, sophisticated investors.

iii. *Some General Comments about the Exemptions*

As previously stated, the fact that a security or transaction is exempt from registration and prospectus requirements does not mean that it is exempt from the anti-fraud provisions of section 17 or of the civil liability provisions in section 12 of the act. It is noteworthy that many of the exemptions are non-discretionary and are available without any approval or review by the SEC. However, it has been held that the burden of proving an exemption is on the person claiming it.[42a]

D. SOME RECENT LEGISLATIVE DEVELOPMENTS

1. *Introduction*

Securities regulation in the United States is an extremely dynamic if not at times volatile subject and recent years have produced a number of important developments to emphasize the rapidity of change in this area. A number of state and federal legislative changes or developments have occurred which are relevant because of their effect on the scope of U.S. securities legislation generally. Although there have been a number of significant state developments,[42b] two examples of federal legislative devel-

42 H. R. Rep. No 85, 73d Cong., 1st Sess. 16 (1933); *see generally* the discussion on points of interpretation that have arisen relating to solicitation and secondary distribution, 1 L. Loss at 697-706.

42a SEC v. Ralston Purina Co., 346 U.S. 119, 126 (1953); *see* 1 L. Loss at 712-13.

42b Some examples are: (a) Iowa's new securities act; *see* Hayes, *The New Iowa "Uniform" Securities Law*, 25 Drake L. Rev. 267 (1975); Hansell & Neumann, *The Iowa Uniform Securities Act Exemptions Part I: The Securities Exemptions*, 2 J. Corp. L. 437 (1977); (b) Wisconsin's administrative rules under its Uniform Securities Act; *see* 5 Wisconsin Securities Bull. 1 (March, 1977); (c) California's Commodity Law which enacts a comprehensive regulation scheme for commodity trading and

opments have been chosen for brief comment.[43] These are the American Law Institute's proposed *Federal Securities Code* and the Securities Reform Act of 1975.

2. *The Federal Securities Code*

With the background of complexity and growth of federal securities regulation, many observers in the United States began to call for a codification of the applicable statutes and rules which the SEC administers.[43a] The American Bar Association's Committee on Federal Regulation of Securities held conferences on codification of the securities laws which led to cooperative support from the SEC and the American Law Institute and the appointment of Professor L. Loss as Reporter for the codification project. Various preliminary drafts and tentative drafts have been prepared and at the time of writing a proposed final draft is near completion.[43b]

Of special relevance to this paper are the *ALI Federal Securities Code*'s proposed definitions dealing with the scope of the code, particularly the definition of a security.[44] Because of its importance, the definition of security is reproduced below:

> "Sec. 297. [Security.] (a) [General.] 'Security' means a bond, debenture, note, evidence of indebtedness, share in

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licensing; *see Review of Selected 1973 California Legislation*, 5 Pacific L.J. 205 (1974); (d) Missouri's securities law and recent amendments to it; *see* Logan, *Missouri's New Uniform Securities Act and Securities Regulations*, 37 U. Mo. K.C.L. Rev. 1 (1969); Logan, *Missouri's Evolving Securities Law and Regulations - Update*, 42 U. Mo. K.C.L. Rev. 341 (1974). In addition there have been numerous special statutes and amendments introduced by the state legislatures on top of the many decisions of the courts and agencies affecting the scope of securities legislation generally. Some of the recent cases are discussed in ch. IV *infra*. *See also* text accompanying notes 20, 21, *supra*.

43 Many other federal legislative changes have been enacted, however; *see e.g.* the Investment Company Amendments of 1970, Pub. L. No. 91-547, 88 Stat. 1413 (1970); the Securities Investor Protection Act of 1970, Pub. L. No. 91-598, 84 Stat. 1636 (1970); the Interstate Land Sales Full Disclosure Act, 15 U.S.C.A. ss. 1701-20 (West 1974) as well as recent amendments to the foregoing and other federal legislation.

43a Notably, Professor L. Loss; *see* Loss, *The American Law Institute's Federal Securities Code Project*, 25 Bus. Law. 27 (1969).

43b *See, Special Symposium Issue: The American Law Institute's Proposed Federal Securities Code*, 30 Vand. L. Rev. 311 (1977); especially Loss, *The Federal Securities Code - Its Purpose, Plan, and Progress*, *id.* at 315. Other contributions in the special issue deal with the substantive provisions of the code.

44 The ALI Federal Securities Code uses "purchase", "buy", "sell" and "offer" to "buy" and "sell"; *see* ALI Federal Securities Code, Reporter's Revision of Tent. Drafts Nos. 1-3, ss. 283, 293 ("Definitions"). Pt. III of the code deals with exemptions: *see* Cheek, *Exemptions under the Proposed Federal Securities Code*, 30 Vand. L. Rev. 355 (1977). The exempt securities under the code are generally those under the Securities Act of 1933 and the Securities Exchange Act of 1934 with certain exceptions; *id.* at 384-94; and for a discussion of exempt transactions under the code, *see id.* at 394-404.

> a company (whether or not transferable or denominated 'stock'), preorganization certificate or subscription, certificate of interest or participation in a profit-sharing agreement, investment contract, collateral-trust certificate, equipment-trust certificate, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, an interest or instrument commonly considered to be a 'security,' or a certificate of interest or participation in, temporary or interim certificate for, receipt for, guaranty of, or warrant or right to subscribe to or purchase or sell, any of the foregoing.
>
> "(b) [Exclusions.] 'Security' does not include (1) currency, (2) a check (whether or not certified), draft, bill of exchange, or bank letter of credit, (3) a note or other evidence of indebtedness issued in a mercantile transaction, (4) an interest in a deposit account with a bank (including a certificate of deposit that ranks on a parity with such an interest) or with a savings and loan association, (5) an insurance policy issued by an insurance company, or (6) an annuity contract issued by an insurance company (except a contract whose benefits vary to reflect the investment experience of a separate account)."

It was the view of the draftsman that the definition of security should, in the words of the commentary to Tentative Draft No. 1,

> "be changed as little as possible, both because there is now a considerable body of jurisprudence and it was substantially followed in the Uniform Securities Act, so that there is now a degree of uniformity at both state and federal levels."[44a]

What is also interesting are the classes of items excluded from the definition.

3. *1975 Securities Acts Amendments: Municipal Securities*

The Securities Reform Act of 1975, or officially, the Securities Acts Amendments of 1975, reflect the most significant changes made in regulatory structure of the securities markets and industry since the Securities Exchange Act was adopted in 1934. There are several major thrusts to the amendments which are beyond the scope of this paper;[44b] however, one relevant change worth special

44a *See* ALI Federal Securities Code, Tent. Draft No. 1, at 52-53; and ALI Federal Securities Code, Reporter's Revision of Tent. Drafts Nos. 1-3, at 34-35.

44b *E.g.* the 1975 revisions have been aimed at making the securities industry more

comment involves the regulatory provisions relating to municipal securities. Financial problems in New York City and elsewhere in recent years have no doubt prompted a new look at the municipal securities field.

Until 1975, the municipal securities market in the United States, one of that nation's largest markets, was almost completely free from regulation under the federal securities laws. Persons offering and selling municipal securities were exempt under section 3(a)(2) of the Securities Act of 1933 from the registration requirements of that act. Under section 3(a)(12) of the Securities Exchange Act of 1934, persons issuing or otherwise trading in municipal securities were exempt from the registration, reporting and related provisions of that act. Although municipal securities were subject to the anti-fraud provisions of the securities laws, cases of this type were few and far between.

The above situation has now been changed by the Securities Reform Act of 1975.[45] A Municipal Securities Rulemaking Board has been established to regulate municipal securities dealers and brokers through the prescription of rules, subject to the oversight of the SEC. The registration and regulation provisions of the Securities Exchange Act of 1934 extend to securities firms and banks which buy and sell municipal securities for their own trading account, and brokers which act only as agent for buyers and sellers and do not buy or sell for their own account. There are other provisions on enforcement and consultation and cooperation among federal agencies relating to municipal securities. Especially noteworthy is the provision stating that the SEC and the new Rulemaking Board are prohibited from requiring an issuer of municipal securities to make any filing with the SEC or board prior to offering any securities. This continues the issuer exemption and

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competitive by ending fixed commissions and directing the SEC to develop a National Market System with the help of a newly-created National Market Advisory Board to make recommendations to Congress on a mechanism or agency to administer the National Market System. The SEC's authority is also strengthened and the broker and dealer registration requirement is extended to previously exempt specialists, floor traders and floor brokers. The authority and requirements of the exchanges and other self-regulatory bodies are more clearly defined. There are new restrictions on trading by exchange members for their own and other accounts. The "back office problems" of the securities industry have been the catalyst for new provisions to regulate clearing agencies, transfer agents and securities depositories and the SEC is directed to formulate the establishment of a national system for the prompt and accurate clearance of securities transactions. *See* Rowen, *The Securities Acts Amendments of 1975: A Legislative History*, 3 SEC. REG. L.J. 329 (1976); Rowen, *Securities Acts Amendments of 1975*, 8 REV. SEC. REG. 889 (June 27, 1975).

45 For a summary explanation and text of the 1975 amendments, *see* Securities Reform Act of 1975, CCH FED. SEC. L. REP. (extra edition June 4, 1975, No. 589).

confirms that the legislation does not contemplate direct regulation of issuers or registration of municipal securities.[45a]

Chapter III
Scope of Canadian Securities Legislation

A. BACKGROUND TO CANADIAN SECURITIES LEGISLATION

Canadian securities legislation, like much of commercial legislation in Canada, is traceable to experience in both the United Kingdom and United States. The English full-disclosure philosophy which originated with the company legislation in the mid-nineteenth century was reflected in the company legislation of Canada, and at the same time the blue sky laws of the United States were reflected in early provincial attempts at securities legislation.[46] In Canada, the United States, and United Kingdom, there is quite a large measure of self-regulation of participants in the securities marketplace, and in North America there is a considerable amount of cooperation among the securities administrators of the various jurisdictions – provincial, state and federal – in both the United States and Canada. Indeed, meetings are held among the North American securities administrators with the aim of cooperation and coordination in mind.

It is not within the scope of this paper to discuss the origin of the Canadian securities legislation and the approaches to securities regulation through such statutes as the companies acts, companies information acts, investment contracts acts and various securities acts. It is interesting that there has been a trend toward uniformity which was emphasized in 1966 with the passage in Ontario of its Securities Act, following the recommendations of the *Kimber Report*, and the subsequent adoption of the Ontario statute in the four western provinces. Today there is even greater uniformity among securities legislation in the country with semi-annual meetings among the provincial administrators and uni-

45a Some commentators have said that the regulation of offerings has been avoided only because the market participants have shown concern for the investors and the continued health of the market through strong self-regulatory efforts. *See* Doty & Petersen, *The Federal Securities Laws and Transactions in Municipal Securities*, 71 Nw. U.L. Rev. 283, 286-87 (1976); *see also* Note, *Federal Regulation of Municipal Securities*, 60 Minn. L. Rev. 567 (1976); Note, *Disclosure by Issuers of Municipal Securities: An Analysis of Recent Proposals and a Suggested Approach*, 29 Vand. L. Rev. 1017 (1976).

46 *Cf.* on historical company law developments in Ontario, Risk, *The Nineteenth Century Foundations of the Business Corporation in Ontario*, 23 U. Toronto L.J. 270 (1973). On early securities law developments, *see* J. Williamson, ch. 1; D. Johnston at 9-15.

form policy statement procedures that have been agreed to by the ten provincial agencies in Canada.[47]

B. CANADIAN LEGISLATIVE TREATMENT OF SECURITIES

1. *General*

As previously mentioned, there are in force in Canada various provincial statutes which deal with the broad question of securities regulation. What has evolved is a pattern of provincial securities acts separate and distinct from the companies acts of the provinces. As previously mentioned, Ontario's new Securities Act in 1966 set the pattern for Canadian provinces to follow. As a result, although there are differences among the provincial statutes, special emphasis will be given to the Ontario statute.[48] It should be noted that many basic provisions are found not only in the statute but also in the regulations made thereunder.

2. *Definition of Security*

a. *Introduction*

Nearly all of the provincial jurisdictions have employed an illustrative definition by using the word "includes" rather than "means".[49] Although there are important variations, generally it can be said that the definitions are quite similar and have tended to be uniform. Some brief comments about the interpretation of some of the terms will be made in this part of the paper, but a fuller discussion of interpretation is found in chapter V.

b. *Specific Ingredients of a Definition of Security in the Ontario Act*

i. *Any Document, Instrument or Writing Commonly Known as a Security*

All the provincial statutes have this wording. It is interesting to note that the United States Securities Act of 1933 uses the wording "any *interest* or instrument commonly known as a security"; the use of "interest" makes the definition broader since a security need not be a written instrument under that act.

The basic question under this heading relates to what is "common knowledge" and how it is to be determined. In one case

47 *See* D. JOHNSTON at 17-18, and app. II.

48 The basic definitions in the provincial acts are listed in four appendices; *see* first footnote to ch. I *supra*. Also included are the definitions under Ontario Bill 98.

49 The one exception is Québec which employs a colon after the defined term.

dealing with commodity futures contracts, the Quebec Securities Commission referred to trade usage and stated:

> "Proof of common knowledge must be based on an overwhelming set of facts and conclusive evidence. On that basis and notwithstanding the fact that they are viewed by the securities industry as speculative opportunities, we are unable to conclude that commodity futures contracts are commonly known as securities in the trade, at the present time."[50]

ii. *Any Document Constituting Evidence of Title to or Interest in the Capital, Assets, Property, Profits, Earnings or Royalties of Any Person or Company*

This heading of the definition is one of the widest in scope. In *Swain v. Boughner*,[51] the Ontario Securities Commission (OSC) appealed the dismissal of a charge that the defendant traded in securities without being registered as a broker or salesman. The alleged securities transaction involved the sale of half interests in a pair of chinchillas and was evidenced by several documents. Along with the sale of the interests, the seller retained the animals under what could be styled a management contract and profit-sharing arrangement. The court held that the transaction was the sale of or trade in securities connected with a sale of specific chinchillas or of an undivided interest in specific chinchillas. In *Regina v. Dalley*,[52] the appellant was convicted of trading in securities without registration. The transaction involved the sale of prospecting permits which he received from the British Columbia Department of Lands and Forests. Upon the payment of fees, the owner obtained an exclusive drilling licence and eventually a lease. Although the court did not hold that the permits were securities, it did decide that the agreement of sale was a security by stating that the document constituted evidence of title to or interest in the property of any person, namely, the appellant. The court also said that the court should not give too broad a definition to security, but where the meaning of the statute was plain, as it appeared to be in the case, the court had to give effect to it.[53]

50 *In re* John T. Geldermann & Co. Inc., 3 OSC Bull. No. 65 (July 11, 1972); *cf.* R. v. Bird and International Claim Brokers Ltd., 43 W.W.R. 241 (B.C.S.C. 1973), which held a mineral claim campaign to be a security under this heading of the definition as well as two other headings. *See* D. JOHNSTON at 27 n. 60.

51 [1948] O.W.N. 141 (H.C.).

52 [1957] O.W.N. 123, 8 D.L.R. (2d) 179 (C.A.).

53 J. Williamson criticizes the decision and provision as too broadly drawn and points out that the U.S. Securities Act of 1933 originally defined security to include "any certificate of interest in property, tangible or intangible" but this was withdrawn because of its breadth and uncertain application; J. WILLIAMSON, SUPP. at 105.

Arguably, arrangements or instruments falling within this heading of the definition would also be caught by the "investment contract" heading, discussed below.

iii. *Any Document Constituting Evidence of an Interest in an Association of Legatees or Heirs*

The wording is pretty much the same in all the provincial statutes. As J. Williamson points out, it is not clear why this provision was included in the statutes. He says that it presumably followed the introduction of the game of "lost heir" in which a promoter informed a large number of people of the existence of a sizable estate (which would be fictitious) and of their possible claim to it and then persuaded them to contribute to a litigation fund.[54]

iv. *Any Document Constituting Evidence of an Option, Subscription or Other Interest in or to a Security*

The original wording of this heading of security read: "any document constituting evidence of an interest in any option given upon a security". The 1966 Ontario Securities Act amendments changed the provision to its present wording. The effect of the change was to make this heading much closer to that of the United States Securities Act of 1933. It is interesting to note that that act also specifically mentions warrant or right to subscribe or purchase; in addition, there is no requirement of any document or writing.

v. *Any Bond, Debenture, Share, Stock, Note, Unit, Unit Certificate, Participation Certificate, Certificate of Share or Interest, Preorganization Certificate or Subscription*

All of these terms would probably be included under the heading "commonly known as a security" since they are examples of what one thinks of when the term security is mentioned. It is interesting to note that the New Brunswick Securities Act specifically includes "promissory note or other commercial paper when traded by the maker or acceptor thereof in the course of continued and successive transactions of a like character".[55]

None of these terms has an entirely precise legal meaning. The reference to unit and unit certificates likely applies to participations in a trust although this does not have to be the case. The reference to preorganization certificate or subscription appears in most of the provincial statutes. Participation certificate and certificate of share interest might have been included under the

54 *Id.* at 108.

55 *See* New Brunswick Securities Act, s. 1.

heading dealing with the evidence of title to or interest in the capital, assets, or property, etc., of any person or company. Participation certificate along with certificate of share interest is fairly broad in its scope and, if it covers an interest in property, then one might argue that it goes too far, whereas if it is limited to participating in profits or earnings, then one might argue that it is proper in scope even though it would overlap with the investment contract definition which is a separate item.[56]

vi. *Any Agreement Providing That Money Received Will Be Repaid or Treated as a Subscription to Shares, Stock, Units or Interests at the Option of the Recipient or of Any Person or Company*

This item appears in many of the jurisdictions, again with several wording variations. It has been pointed out that, although the provision possibly covers a loophole in the subscription coverage, in that a contribution may not be a subscription until the choice of the recipient makes it so, it seems likely that such an arrangement would be treated as a subscription anyway so that the provision probably serves no purpose.[57]

vii. *Any Certificate of Share or Interest in a Trust, Estate or Association*

This provision is in all the jurisdictions except Québec which has not included the "or association". The 1966 Ontario Securities Act, by adding a comma, changed the provision from "trust, estate or association" to read "in a trust, estate, or association". If "security" is defined to include an interest in a person and "person" is defined to include a trust, estate or association, this heading becomes unnecessary.

viii. *Any Profit-Sharing Agreement or Certificate*

This provision is present in all the Canadian legislation and in substantially the same form. It also appears in U.S. legislation and would appear to overlap with the interpretation given certain types of securities listed in the definition, namely, participation certificates, certificate of share or interest and, indeed, an investment contract. However, it is arguable that it is not superfluous to have the separate heading to make it absolutely clear that such an arrangement is a security.

56 *See* J. Williamson, Supp. at 109, where he argues that to ensure coverage of any interest in earnings and profits generally, it might be better to use the term "interest or participation in the profits, earnings or royalties of any proposed or existing company or person".

57 *Id.* at 113.

ix. *Any Certificate of Interest in an Oil, Natural Gas or Mining Lease, Claim or Royalty Voting Trust Certificate*

Oil and gas and related interests have been quite differently treated among the various provincial securities statutes.[58] The differences include both wording and punctuation variations. There are several other headings which deal with such interests and a comprehensive heading is much needed.[59]

x. *Any Oil or Natural Gas Royalties or Leases or Fractional or Other Interest Therein*

Several provincial jurisdictions include this item. As previously mentioned, the United States Securities Act of 1933 refers to a "fractional undivided interest in oil, gas or other mineral right".[60] It is questionable whether an oil or natural gas lease should be included as a security since one wonders why this form of lease is more of a security than any other.

xi. *Any Collateral Trust Certificate*

This term is present in all the Canadian provincial legislation except that of Québec. It has been noted that this term is probably within the "commonly known as security" heading but there may be some doubt.[61]

xii. *Any Income or Annuity Contract Not Issued by an Insurance Company or an Issuer within the Meaning of the Investment Contracts Act*

This definition excludes income or annuity contracts issued by an insurance company or an issuer within the meaning of the Ontario Investment Contracts Act on the grounds that these types of arrangements will be regulated under insurance and investment contracts legislation. Some provinces exclude only the insurance company contracts but not those issued by an issuer under the investment contract statute.[62] Under this act, issuers and salesmen must register, deposits of assets are required, and investment powers are specified.

The Ontario Investment Contracts Act[63] does not define an income or annuity contract, but the effect of the definition of

58 *Id.* at 109-11.

59 Williamson suggests: "any certificate of interest in an oil, natural gas, or mining lease, claim or royalty or trust or any interest therein", J. WILLIAMSON at 113; *but* J. WILLIAMSON, SUPP. omits the suggestion as such.

60 *See* text accompanying notes 14, 15 *supra.*

61 J. WILLIAMSON, SUPP. at 107.

62 *Id.* at 113.

63 R.S.O. 1970, c. 226.

"issuer" and "investment contract" under that act is that an income or annuity contract issued by a corporation other than an insurance company or "investment contract issuer" will come under this heading of security under the securities statute.[64]

xiii. *Any Investment Contract, Other Than an Investment Contract within the Meaning of the Investment Contracts Act*

An investment contract within the meaning of the Ontario Investment Contracts Act is an agreement to pay a fixed sum on a specified date, containing optional settlement values with cash surrender or loan privileges having instalment or single sum payments, but excluding contracts within the meaning of the Ontario Insurance Act.[65]

It is the two words "investment contract" which have given rise to a vast number of interpretations, both administrative and judicial, in Canada and the United States. The phrase has generated more comment about its meaning than any other heading in the list of definitions of securities; more about the term will be discussed below.[66]

c. *Other Definitions*

As discussed by J. Williamson, there are several other definition headings found in the various provincial laws.[67] For example, in the regulations of Newfoundland, Prince Edward Island and Nova Scotia, reference is made to agreements of sale and purchase by instalment or otherwise. As noted by Williamson, this heading is beyond any reasonable scope of the securities act. Also mentioned in regulations of New Brunswick, Newfoundland, Nova Scotia and Prince Edward Island are agreements to purchase any fur-bearing animal which is not to be appropriated to the contract or cannot be identified as so appropriated. Such agreements can amount to investment contracts or profit-sharing agreements which have already been covered.[68]

64 *See* D. Johnston at 29-30. Johnston points out that the definition of "income or annuity contract" is not exhaustive for purposes of the Ontario Securities Act so that it is conceivable that an agreement could fall within a broader meaning of "income or annuity contract", in which case it could be held to be a security, notwithstanding that it was issued by an insurance company or issuer as defined by the Ontario Investment Contracts Act; *id.* at 30.

65 The Ontario Investment Contracts Act, s. 1(b). The Québec securities statute does not refer to an investment contract as a security.

66 *See* chs. IV, V *infra*.

67 J. Williamson, Supp. at 113-15.

68 Other examples are: any contract or agreement to give advice or information concerning investments; membership in any organization, league or association, whether incorporated or not, which has for its object the rendering of a special

d. *Summary*

In short, the Canadian definitions of security contain much overlap among the definitional headings, appear to have been added to in a rather *ad hoc* manner, and are extremely broad in scope. There is no requirement of a document or writing since an oral agreement is sufficient for some headings of the definition. In some cases the instrument itself is treated as a security and in others the legal relationship is.[69] Finally, in many statutes, express regulatory power is conferred to expand the definitional headings of security.[70]

3. *Definition of Trade or Trading*

Section 1(1)24 of the Ontario Securities Act[71] defines "trade" or "trading" to include:

> "(i) any sale or disposition of or other dealing in or any solicitation in respect of a security for valuable consideration, whether the terms of payment be on margin, instalment or otherwise, or any attempt to do one of the foregoing,
>
> "(ii) any participation as a floor trader in any transaction in a security upon the floor of any stock exchange,
>
> "(iii) any receipt by a person or company registered for trading in securities under this Act of an order to buy or sell a security, and
>
> "(iv) any act, advertisement, conduct or negotiation directly or indirectly in furtherance of any of the foregoing."

Since the word "includes" introduces the subparagraphs, the definition of trade is not exhaustive. Also noteworthy is the requirement of valuable consideration so that a gift would not be a trade. It has been stated that the Ontario Securities Act is a "selling" act rather than a "dealing" act which is aimed to require compliance with the act by sellers as opposed to buyers of securities.[72] However, the words "or other dealing in" in subparagraph (i) and the broad wording of subparagraph (iv) could be interpreted as meaning "buying" as well.[73]

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protective service or services to motorists or other special services; any document constituting evidence of an interest in a scholarship or educational plan or trust; *id.*

69 D. JOHNSTON at 23 n. 41.

70 *E.g.* New Brunswick, Nova Scotia, Prince Edward Island and Newfoundland Securities Acts.

71 R.S.O. 1970, c. 426.

72 D. JOHNSTON at 34.

73 The definition of trade or trading in Ontario's proposed Securities Act (Bill 30),

One writer has illustrated the very broad scope of the definition of trade with the following examples:

> "a telephone call by a customer instructing his broker to sell a security, the mailing of a confirmation slip to the customer by the broker, the publication of a market letter or a newspaper advertisement concerning a security, in addition to the actual offer for sale of a security, the acceptance thereof and completion of the resulting contract, are all acts which constitute trading."[74]

Several cases have interpreted the definition of trade in some of the provincial securities statutes. The Saskatchewan statute was at issue in *Prudential Trust Co. Ltd. v. Forseth and Forseth*[75] in which the Supreme Court of Canada held no trade took place where an oil lease was granted to a company by a farmer who subsequently assigned, subject to the lease, an undivided one-half interest in all oil rights in the land to the defendant, receiving cash in return. The transaction was characterized by the court as a purchase of an interest in mineral rights and the acquisition of an option to lease mineral rights. The court stated that the securities act definition of trade contemplated solicitations for the making of sales but not for the making of purchases.[76]

In *Re Sanderson and Ontario Securities Commission*[77] the Ontario Court of Appeal construed a gambling scheme that employed newspaper advertisements to solicit deposits which were to be used in betting on horseraces in the United States. The court held that the arrangement was a security, and a trade was involved since the acts constituted "other dealing" within the definition of trading in the Ontario Securities Act.

On the other hand, the acts of a firm which provided account-

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discussed in note 138 *infra*, is clearer in this respect since it does not have the words "or other dealing in" and expressly provides that a purchase is not included. However, this wording poses interpretive difficulties when one examines other provisions of the act; *see e.g.* Ontario Bill 30, s. 132, dealing with liability for unlawful trades, which include takeovers; a takover involves a purchase of securities and hence does not fit the use of trade in s. 132.

74 Dey, *Exemptions under the Securities Act of Ontario*, in Law Society of Upper Canada, Special Lectures: Corporate and Securities Law 127, 129 (1972).

75 [1960] S.C.R. 210, 21 D.L.R. (2d) 587 (1959).

76 [1960] S.C.R. at 225 (*per* Martland, J.). For a companion case, *see* Prudential Trust Co. Ltd. v. Olson, [1960] S.C.R. 227, 21 D.L.R. (2d) 603. These cases should be contrasted with Meyers v. Freeholders Oil Co. Ltd., [1960] S.C.R. 761, 25 D.L.R. (2d) 81, which also dealt with the Saskatchewan statute. In that case the defendant company issued shares as consideration for the assignment of mineral rights and argued that the transaction was in effect an agreement to acquire mineral rights to which the issuance of shares was incidental. The court held that a trade was involved because defendant's argument could not prevail where the agreement itself contained the provision for the issuance of shares.

77 [1972] 3 O.R. 329, 28 D.L.R. (3d) 171 (C.A.); also discussed in note 371 *infra*.

ing and administrative services to mutual fund dealers did not constitute trading under the Ontario act.[78] The defendant firm received a commission for handling and arranging funds for investment, which funds came from periodic payments from mutual fund subscribers and dividends and interest from the fund. Stark, J., held that because the services were merely administrative the firm was not a dealer. In addition the trade which was the subject of registration under the act had already been completed and there was no "furtherance" of trade as a result.[79]

A fundamental question arising from the definition of trade relates to where the trade takes place. This question in turn is concerned with the territoriality or reach of the provincial securities statutes. As a general rule, a province's laws extend only as far as its borders.[80] Could the acts which constitute trading be split among two or more provinces such that each province could take jurisdiction or alternatively neither would be able to do so? In one case,[81] the Supreme Court of Canada upheld action taken by the Quebec Securities Commission against a company with its head office in Montréal that published and mailed weekly bulletins relating to shares of companies to persons who resided outside Québec. The Court in effect held that the initiation of trading activities within a province's borders gave it jurisdiction.[82]

4. *Definition of Distribution to the Public*

A person who trades in a security must register or obtain a licence under the appropriate provincial securities act unless such person can come within one of the statutory exemptions.[83] Reflecting another theme of securities regulation, namely, full, true and plain disclosure of all material facts relating to the security to be issued, a person who trades in a security where such trade would be a "distribution to the public" must comply with the prospectus provisions of the securities act[84] unless a statutory exemption can

78 Re Ontario Securities Commission and C.A.P. Ltd., [1972] 1 O.R. 205, 22 D.L.R. (3d) 529 (H.C.).

79 As noted by Johnston, the decision is sensible but the reasoning is less satisfying; *see* D. Johnston at 35 n. 93.

80 *Id.* at 36, *citing* Hretchka v. Attorney-General for British Columbia, [1972] S.C.R. 119, 19 D.L.R. (3d) 1 (*per* Martland, J.).

81 Gregory and Co. Inc. v. Quebec Securities Commission, [1961] S.C.R. 584, 28 D.L.R. (2d) 721.

82 *See also* R. v. W. McKenzie Securities Ltd., 56 D.L.R. (2d) 56 (Man. C.A. 1966) where the court held that an Ontario-located broker telephoning Manitoba residents amounted to trading in Manitoba requiring registration under the Manitoba statute.

83 *See e.g.* s. 6(1)(a) of the Ontario Securities Act.

84 Section 35 of the Ontario Securities Act prohibits a distribution to the public unless

be found. Thus the definition of "distribution to the public" is of paramount importance.

Paragraph 6a of section 1(1) of the Ontario Securities Act defines "distribution to the public" as *meaning*:

> "(i) trades that are made for the purpose of distributing to the public securities issued by a company and not previously distributed to the public, or
>
> "(ii) trades in previously issued securities for the purpose of distributing such securities to the public where the securities...are derived from the holdings of any person, company or any combination of persons or companies holding a sufficient number of any of the securities of a company to materially affect the control of such company...."[85]

In short, (a) any person trading with the public in securities not previously distributed to the public, or (b) a "control person" trading with the public, must comply with the prospectus requirements set forth in the statute.[86] Although the effect of the definition can be rather easily summarized, the exact meaning of the scope of the definition is another story.

Central to the definition is the meaning of what constitutes the "public". There have been a number of cases and countless opinions expressed as to the meaning of the term which have drawn on the U.S. and U.K. experience. Not much can be gained by reviewing these authorities since they have been well canvassed elsewhere.[87] One commentator has succinctly summarized the matter by stating that Canadian law distinguishes among three classes of people:

> "(1) those who are not members of the public either because
>
> "(a) they do not have a need to know the information contained in a prospectus, or

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the prospectus provisions are complied with. Again, however, there are exemptions from the prospectus requirements which are discussed below.

85 The emphasis is supplied because the definition does not use "includes" as do the definitions of "security" and "trade" or "trading". It is interesting that the latter terms are the only defined terms in s. 1(1) which employ the non-exhaustive form "includes" rather than the exhaustive "means".

86 Section 66 of the Ontario Securities Act extends the prospectus requirements to securities of persons other than companies, which are the only entities mentioned in the definition of distribution to the public.

87 The leading and more helpful cases are Nash v. Lynde, [1929] A.C. 158 (H.L.); SEC v. Ralston Purina Co., 346 U.S. 119 (1953); R. v. Piepgrass, 23 D.L.R. (2d) 220 (Alta., C.A.1960); R. v. McKillop, [1972] 1 O.R. 164 (Prov. Ct.) and are well discussed in D. Johnston at 148-55; Dey, *supra* note 74, at 134-40.

"(b) they are close friends or business associates of an issuer,

"(2) those who are members of the public, and

"(3) those who are members of the public but have been statutorily exempted from the forced disclosure provisions."[88]

It is particularly noteworthy that Ontario's proposed new securities act has deemphasized the "public" concept by eliminating it from the definition of distribution[89] and almost entirely from other provisions of the act.[90]

Also problematic with respect to trades and resales is the meaning of "not previously distributed to the public" which appears in the first branch of the definition of "distribution to the public", and "previously issued securities" which appears in the second branch of the definition.[91]

5. *Exemptions from Registration and Prospectus Provisions*

a. *General*

Having examined the definitions of "security", "trade" and "distribution to the public" in the Ontario Securities Act as the Canadian model, one can easily conclude that such definitions give an extremely wide scope to the coverage of the act. Without specific exemptions it would be unusual to have a securities transaction which was not in some way subject to the registration or prospectus provisions or both. Thus the approach taken by the act is to assume the need for protection of the act for everyone and to stipulate situations where for some reason the act's regulatory provisions need or should not apply. Although there is considerable overlap, the exemptions can be divided into those relating to registration, and prospectus requirements, whether by specific statutory provision or exemption made by order of the OSC on application by an interested party.

As previously mentioned, section 6 of the Ontario Securities

88 D. Johnston at 154-55.

89 *See* s. 1(1)12 and s. 54 of Ontario Bill 30. The proposal to eliminate the concept was based on the recommendation of the Ontario Securities Commission Disclosure Report. The report argued that since regulation under the securities statute was all-inclusive with residual discretion in the OSC, the reference to "public" should be dropped. This would result in a prohibition of a "distribution" to anyone unless a prospectus had been accepted for filing; *see id.* ¶ 3.20.

90 One instance where the concept remains is in the exemptions from registration, s. 35(2)(12), and from prospectus filing, s. 74(1)(a), which refer to "[s]ecurities of a private company where they are not offered for sale to the public". However, this limited retention of the concept is not nearly as perplexing as the role of "public" in the present legislation.

91 *See* Dey, *supra* note 74, at 140-44.

Act requires registration of various persons who trade in securities.[92] Section 18 provides exemptions from registration as an adviser under section 6(1)(e). Section 19(1) and 19(3) provide exemptions from registration with respect to some eleven specific trades, and section 19(2) provides exemptions with respect to trades in thirteen specified securities.

The exemptions from the prospectus requirements are described in section 58. While incorporating many of the registration exemptions in section 19, section 58 is not as comprehensive as the latter.

In addition to the foregoing specific statutory exemptions, sections 20 and 59 of the Ontario Securities Act provide for discretionary power in the OSC to grant an exemption.[93] Both sections (a) give the OSC power to exempt an applicant from the registration and prospectus requirements if, in the opinion of the OSC, it would not be "prejudicial to the public interest" to do so, and (b) allow the OSC to subject the exemption to such terms and conditions as the OSC decides to impose. However, as has been noted, there are several important differences between the two sections.[94] It is interesting that Ontario's proposed Securities Act

92 The prohibition in s. 6 against trading without registration is expressed as persons trading in a security unless registered as:
(a) a dealer or salesman of a registered dealer;
(b) a partner or officer on behalf of a person or company;
(c) a salesman on behalf of a person or company;
(d) an underwriter; and
(e) an adviser.

93 For a discussion of the two Ontario sections *see* D. JOHNSTON at 236-39; Dey, *supra* note 74, at 174-81. As Johnston notes, there is wide variance in the approach taken by the provinces ranging from similarity to the Ontario sections to not having similar provisions; D. JOHNSTON at 236 n. 373.

94 *See* D. JOHNSTON at 236-39. Some of the major differences are:
(a) Section 20(2) requires notice of a s. 20 order and a summary of facts to be published as soon as possible and the order to be laid before the Legislative Assembly if in session. There is no similar requirement for s. 59 orders.
(b) A s. 20 order is subject to appeal whereas s. 59(4) states that a ruling of the commission under the section is final and without appeal.
(c) Section 20 is rarely used compared to s. 59; *see In re* J.D. Carrier Shoe Co. Ltd., [1967] OSC Bull. 32 (September); *In re* Hawkesbury Golf and Curling Ltd., [1968] OSC Bull. 161 (July).
(d) Section 20 is broader in that it applies to any trade, security, person or company named in the order whereas s. 59 relates only to a trade or intended trade. In addition, s. 59 allows a s. 6 exemption only as a supplementary order to the application for an order that the trade is not deemed to be a distribution to the public.
(e) The OSC has issued policy statements on s. 59 applications; *see* OSC Policy No. 3-18, April 5, 1971, CCH CAN. SEC. L. REP. ¶ 54-912; and OSC Policy No. 3-18A, May 9, 1974, CCH CAN. SEC. L. REP. ¶ 54-912A. Applicable to both s. 20 and s. 59 applications is OSC Policy No. 3-19, December 6, 1971, CCH CAN. SEC. L. REP. ¶ 54-913 (Applications to the Commission Re Rulings-Procedure). For a discussion on the nature and effect of the rulings made by the OSC on resales made by the applicants

contains only one discretionary exemption section which is analogous to the present section 59 in that it sets forth similar conditions and powers for the exercise of the exemption discretion.[95]

b. *Rationale of the Specific Exemptions*

Before dealing directly with specific exemptions from the registration and prospectus requirements, it might be useful to discuss the rationale for the specific exemptions found in the statute. A basic rationale for the exemptions is that in situations covered thereby there is no need to have the protection of the securities act. It would seem that this reason can exist where, for example, the parties involved in the transaction are able to fend for themselves, where the issuer or vendor is a person subject to fairly intense regulation already so that additional regulation under the securities statute is superfluous and wasteful, or where the security being traded is of an issuer of obvious integrity such that the securities act need not apply.

A second rationale for the exemptions relates to cost-benefit considerations in that the transaction costs of compliance with the securities act outweigh the benefits obtained by requiring compliance. In some situations, for example, where the security trading is insignificant in terms of frequency and economic impact, it is impractical to require compliance with the act. In addition there may be certain transactions which are of a special or extraordinary nature which, by a business efficiency or commercial expediency standard, compels freedom from compliance with the securities statute.

A third rationale for exemptions in provincial securities statutes is the avoidance of constitutional confrontations. For example, some exemptions can be explained by the unwillingness of a province to regulate a federally created and regulated entity through the province's securities act.

It is difficult to identify all the reasons for the specific exemptions.[96] Of course, one hopes that, although effective lobbying for exemptions by affected groups may take place, such lobbying *per se* is not a basic reason for granting exemptions.

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who have obtained favourable s. 59 rulings, *see* Dey, *supra* note 74, at 175-76; D. JOHNSTON at 238.

For the Alberta and B.C. policy statements *see* D. JOHNSTON at 237 n. 378.

95 Ontario Bill 30, s. 75.

96 *See* D. JOHNSTON at 118; Dey, *supra* note 74, at 131-32.

c. *Specific Exemptions*

i. *Introduction*

As previously discussed, a person is not subject to the registration or prospectus requirements if the transaction involved does not come within the definition of security, trade or distribution to the public. In addition, there are specific exemptions under the Ontario Securities Act which can be classified as registration exemptions only, prospectus exemptions only, and both registration and prospectus exemptions. Within each of these groups, further subclassifications can be identified, namely, exempt trades, exempt securities, exemption by the regulations, and discretionary exemption orders (sections 20 and 59 of the Ontario Securities Act, which have already been discussed). Finally, the statute contains specific provisions on the denial of registration exemptions. What follows is a brief discussion of the exemptions under the classifications just mentioned.[97]

ii. *Exemptions from Registration Requirements*

Section 18 of the Ontario Securities Act deals with exemptions from registration as an adviser under section 6(1)(e). The persons exempted are: (a) banks, trust and loan companies and insurance companies,[98] (b) specified professionals (lawyer, accountant, engineer, teacher) "whose performance of...services is solely incidental to the practice of...[their] profession", (c) a person or company registered for trading under the act "...whose performance of...services is solely incidental to the conduct of his or its business as such", (d) disinterested publishers giving advice through their publication as solely incidental to their business and not receiving any consideration for giving the advice, and (e) other persons designated by regulations.[99] The above exemptions contain many interpretive questions and consequently must be approached with much caution.[100]

Section 19 of the Ontario Securities Act lists both trades and

97 For a fuller treatment *see* Dey, *supra* note 74, at 144-81; D. Johnston at 117-34, 189-239.

98 It has been stated that the exemption of the federally chartered banks and the Federal Business Development Bank "...is in part to avoid sensitive constitutional issues": D. Johnston at 119.

99 No regulations have been passed under this provision. It is interesting that s. 33(e) of Ontario Bill 30 adds a "management company" to the list of exemptions under this heading. In addition, s. 34 provides for the exemption from registration as a mutual fund (required by s. 24(1)(d)) of an investment club meeting prescribed tests of size and operation, a trust company, and an insurance company.

100 For some interesting comments on the interpretation of the s. 18 exemptions, see D. Johnston at 119-22.

securities which are exempt from registration. Those which are exempt only from the registration requirements will be discussed here with the others being discussed under the heading dealing with exemptions from both registration and prospectus requirements. The section 19 registration exemptions deal only with the following exempt trades: judicial trades, isolated trades, special institutional trades, specified employee trades, agent trades, and finally trades exempted by regulations.

Section 19(1)1 of the Ontario act exempts trades at a judicial sale involving any one of a number of officials including an executor, administrator, guardian, committee, authorized trustee or assignee, receiver or custodian under the Bankruptcy Act (Canada), receiver under the Judicature Act or liquidator under the Ontario Corporations Act, the Ontario Business Corporations Act or Winding-Up Act (Canada). The exemption reflects the special nature of the transaction and the fact that with the judicial supervision of the party trading, registration under the act is not necessary.

The isolated trades exemption in section 19(1)2 is clouded by several questions of interpretation. The exemption is described as "an isolated trade in a specific security by or on behalf of the owner, for the owner's account...not made in the course of continued and successive transactions of a like nature, and [not] by a person or company whose usual business is trading in securities". Several questions arise: what is isolated and what time frame is applicable to measure it?[101] What is meant by a *specific* security? What is meant by "by or on behalf of the owner, for the owner's account"? And finally, what is the meaning of "not made in the course of continued and successive transactions of a like nature"?[102] The rationale of the exemption clearly relates to allowing the "amateur" holders of securities to dispose of their securities without having to register under the securities act since to require such registration would act as a real disincentive to the acquisition of securities as investments.

Section 19(1)3 allows an exemption where a party to the trade is an institution that is already subject to fairly comprehensive government regulation, or where the purchaser is a person, other

101 *See* R. v. McKillop, [1972] 1 O.R. 164 (Prov. Ct.) where the court held that some ten trades over a 20-month period were not isolated. The court emphasized the plurality of transactions stating that isolated meant a single transaction; *id.* at 167. *See also* R. v. Malcolm and Olson, 42 D.L.R. 90 (Alta. C.A. 1918); Canadian Bank of Commerce v. Johnson, [1926] 4 D.L.R. 1179 (Alta. C.A.).

102 For a discussion on the question, *see* D. Johnston at 112-16.

than an individual, recognized by the OSC as an "exempt purchaser".[103]

Section 19(1)4 exempts a trade made by a pledgee, mortgagee or other encumbrancer for the purpose of liquidating a *bona fide* debt by selling a security pledged or encumbered in good faith as security for the debt. Again from a business expediency standpoint, the exemption makes sense since there will generally be only one transaction and requiring registration will increase the transaction costs of the pledge unnecessarily.

Section 19(1)5 provides that registration is not required with respect to "a trade in a security that may occasionally be transacted by employees of a [registrant] where the employees do not usually sell securities to the public and have been designated by the Director as 'non-trading' employees, either individually or as a class". It is difficult to see the underlying reason for this exemption.[104]

Section 19(1)7 provides an exemption for trades by persons acting solely through an agent who is a registrant. As has been pointed out, this exemption is important since it is relied on by investors trading through, *inter alia*, the Toronto Stock Exchange.[105]

Finally, section 19(1)11 provides for exemption from registration by regulations, but no such regulations have been passed in Ontario to date.[106]

iii. *Exemptions from Prospectus Requirements*

The exemptions from prospectus requirements, which are found in section 58 of the Ontario Securities Act, can be classified into three groups: (1) those which repeat and adopt the registration exemptions in section 19, (2) those which adopt but modify the registration exemptions in section 19, and (3) those which are found only in section 58. The prospectus exemptions in groups (2) and (3) will be discussed under this heading and those in group (1) will be dealt with in the next section.

There are two registration exemptions which are altered in section 58, both of which are important. First, section 58(1)(a) modifies the institutional and exempt purchaser trade in paragraph 3 of section 19(1) to require that the purchaser or proposed

103 *See* s. 7 of the Ontario Securities Regulations which prescribes the form for the application and other conditions.

104 According to Dey, *supra* note 74, at 170, the exemption has been provided as a matter of convenience to registrants.

105 *Id.*

106 As noted by Johnston, several other provinces use the regulations power to grant exemptions whereas Ontario uses the act; *see* D. JOHNSTON at 128 n. 174.

purchaser contemplated by the exemption must be purchasing "...as principal for investment only and not with a view to resale or distribution".[106a] The requirements of purchasing as principal and investment intent introduce two elements to the prospectus exemption not found in the registration exemption in section 19(1)3.[107] A major problem of interpretation relates to the requirement of investment intent.[108] The second alteration in section 58 is that the so-called private placement exempt trade in section 19(3) is amended by section 58(1)(b) to require that the purchaser or proposed purchaser is also acquiring as principal.[109]

The prospectus exemptions found only in section 58 deal with trades between registrants, statements of material facts, trades by control persons, and exemptions by regulation. Section 58(1)(d) provides that section 35 does not apply to a trade in the course of a distribution to the public where the trade is made from one person or company registered for trading in securities to another person or company registered for trading in securities, where the purchaser is acting as principal. One can assume that the theory for this exemption from prospectus qualification is that registrants are probably able to fend for themselves and thus do not need the protection that a prospectus would afford them under the Ontario Securities Act.[110]

Section 58(2)(b) of the Ontario act provides that section 35 does not apply to a distribution to the public of securities that are listed and posted for trading on any stock exchange recognized by the OSC where such securities are distributed to the public through the facilities of such stock exchange pursuant to the rules thereof and the requirements of the commission, if a statement of material facts, which complies with the regulations as to form and content, is filed with and is acceptable to the stock exchange and

106a However, a trust company investing for accounts fully managed by it, such as pension funds, is deemed to be acting as principal for purposes of Ontario Securities Act ss. 58(1)(a), (b), (d); *see* s. 58(1)(a).

107 The modifications are traceable to the concerns expressed in the Ontario Securities Commission Disclosure Report relating to purchasers buying securities through institutions exempt from registration and prospectus requirements; *see id.* at ¶ 5.15.

108 In addition, the regulations to the act require a report to be filed in connection with such investment intent. For a discussion of investment intent and the reporting requirements under the act as well as the Toronto Stock Exchange, *see* Dey, *supra* note 74, at 147-51.

109 Both ss. 19(1)3 and 19(3) expressly exclude an individual from the exemptions. Since s. 19(3) on private placements already provides for an investment intent requirement, there is really not much difference in substance between the 19(1)3 and 19(3) exemptions. The major difference is that the latter exemption requires a minimum acquisition cost to the purchaser of not less than $97,000.

110 Dey, *supra* note 74, at 171; D. Johnston at 201.

commission.[111] The statement of material facts, which has been usually associated with mining company issuers, is similar to a prospectus, and by section 58(3) it is deemed to be a prospectus for purposes of the sections providing remedies to purchasers of securities for false or misleading statements: sections 64, 65 and 142 of the act.[112]

Section 58(2)(c) provides that section 35 does not apply to a distribution to the public of securities that are listed and posted for trading on any stock exchange recognized by the commission where such securities are distributed to the public within the meaning of section 1(1)6a.ii[113] through the facilities of such stock exchange by way of isolated trades not made in the course of continued and successive transactions of a like nature. It is important to note that the exemption is available only to a "control person" under the second branch of the definition of distribution to the public as previously discussed.[114] One of the difficulties of this prospectus exemption is the meaning of the words "isolated trades not made in the course of continued and successive transactions of a like nature". This wording was discussed above[115] since it appears in section 19(1)2; but trade is singular in that provision whereas it is pluralized in section 58(2)(c), which may further cloud the issue.[116]

Section 58(2)(d) states that section 35 does not apply to a distribution to the public of securities that are exempted by the regulations. One regulation enacted under this section deals with puts and calls and is subject to several conditions.[117]

111 In OSC Policy No. 3-17, April 5, 1971, CCH Can. Sec. L. Rep. ¶ 54-911, the OSC recognizes the Toronto Stock Exchange but it has recognized the Alberta Stock Exchange for purposes of the statement of material facts exemption, and will apparently recognize others for specific purposes; *see* D. Johnston at 229-30, 393.

112 Sections 51 to 63 of the Ontario Securities Regulations provide for the content of the statement. *See also* form 23 of the regulations and OSC Policy No. 3-05, April 5, 1971, CCH Can. Sec. L. Rep. ¶ 54-899. The Toronto Stock Exchange also has a detailed policy on the statement of material facts; *see* Dey, *supra* note 74, at 172.

113 The reference in the statute is erroneously stated to be ¶ 13 of s. 1(1).

114 It is interesting to note that, for making isolated trades, it is preferable to be a control person rather than an ordinary shareholder holding shares "not previously distributed to the public" since the latter, unlike the former, does not have a similar prospectus exemption for isolated trades.

115 *See* text accompanying notes 101, 102 *supra*.

116 Dey, *supra* note 74, at 173, suggests that the exemption would be available for prearranged trades which are "crossed" on the stock exchange but would not be available to the control person who requested his broker to "dribble" his shares out over a period of time without restriction.

117 *See* Ontario Securities Regulations, s. 86. This exemption regulation is a consequence of the decision of the OSC to permit members of the Toronto Stock Exchange to trade in options of the Chicago Board Options Exchange; D. Johnston at 230 n. 357. Section 87 exempts trades in securities issued on the conversion of a security previously issued to the public by a reporting issuer.

iv. *Exemptions from Both Registration and Prospectus Requirements*

The exemptions from registration and prospectus requirements[118] are based primarily on the qualities of the persons trading or the nature of the securities involved. A brief description of these exemptions is given followed by a discussion of circumstances relating to denial of exemptions.

aa. Exempt Trades

Sections 19(1)6 and 58(1)(c) exempt from both registration and prospectus requirements a trade between a person or company and underwriter acting as purchaser, and trades between or among underwriters. Under the definition in section 1(1)25, an underwriter can act either as principal or agent. As the former the underwriter purchases securities with a view to distribution to the public; as agent the underwriter offers or sells securities in connection with a distribution to the public. An important question of interpretation relates to the scope of the exemption from registration, that is, whether section 19(1)6 exempts from all registration requirements or only from registration as a dealer under section 6(1)(a). Under the latter interpretation registration as an underwriter is required to be entitled to the exemption in section 19(1)6.[119]

A number of registration-prospectus exemptions relate to trades by a company with its shareholders. Sections 19(1)8 and 58(1)(c) exempt trades by a company:

(i) in its own securities by way of stock dividend;

(ii) of securities pursuant to a *bona fide* reorganization[120] or winding up or distribution of its assets for the purpose of winding up its affairs;

(iii) of its securities pursuant to a "rights offering". [121]

With respect to the stock dividend and reorganization exemptions, section 19(1)8 stipulates that no commission or other remuneration may be paid except for ministerial or professional services.

Paragraphs 9, 9a, and 9b of section 19(1) exempt certain kinds

118 *See generally* Meech, *Prospectus and Registration Requirements*, in Law Society of Upper Canada, Special Lectures: Developments in Company Law 211 (1968).

119 *See* Dey, *supra* note 74, at 152.

120 On the meaning of reorganization in this context *see* R. v. Santiago Mines Ltd., [1947] 1 D.L.R. 642 (B.C.C.A.). Some guidance on the meaning of *bona fide* can be gleaned from *In re* Panacea Mining & Exploration Ltd., [1971] OSC Bull. 156 (October).

121 With respect to the many interpretive questions involved in the three exemptions and the various policy statements relating thereto, *see* Dey, *supra* note 74, at 153-57; D. Johnston at 203-11.

of transactions that could be styled as "business combinations". The rationale for the exemptions from registration and prospectus requirements relates to the fact that the "purchasers" will already be receiving considerable information relating to the transaction pursuant to the corporation law requirements or other provisions of the Ontario Securities Act, *e.g.*, the takeover bid provisions; or, because a small number of shareholders is involved, the protection afforded by the act need not be invoked. One can surmise that in such circumstances the small group of persons could get the material information through discussions leading to the particular transaction. Specifically the exemptions provided under this topic are:

(i) trades in securities exchanged in connection with:
  (a) a statutory amalgamation or arrangement;
  (b) any other "merger or consolidation";[122]
  (c) a takeover bid under Part IX of the act;
(ii) trades in connection with offers to purchase
  (a) shares by private agreement with less than fifteen shareholders; or
  (b) all of the shares in a private company;
(iii) trades in a security by a company as consideration for a portion of or all of the assets of a person, other than an individual, or company who agrees to hold the securities for investment only and not with a view to resale or distribution, if the fair value of the assets so purchased is not less than $100,000.[123]

Based on a recommendation in the *Ontario Securities Commission Disclosure Report*,[124] sections 19(1)9c and 58(1)(c) exempt trades by companies to their promoters[125] from the registration-prospectus requirements. Again it can be argued that the exemption is sound because promoters are likely to have access to, or the

122 "Merger" and "consolidation" are U.S. terminology and the specific exemption in Ontario Securities Act s. 19(1)9b describes what takes place in a merger or consolidation under the corporation statutes of many states.

123 The assets acquisition is found in Ontario Securities Act s. 19(1)9b and is similar to the private placement exemption found in s. 19(3). It is not exactly clear why an investment intent is required or, put another way, why ¶ 9b should be analogized to the private placement exemption at all.

124 Ontario Securities Commission Disclosure Report ¶ 8.08. Without such an exemption, a sale of shares by a company to its promoters arguably offended both the registration and prospectus requirements unless a private company was involved since its securities are exempt.

125 "Promoter" is defined in Ontario Securities Act, s. 1(1)15. Like several exemptions the promoters' exemption relates to companies; *see also* the trades to employees exemption under s. 19(1)10. Arguably the exemption should be extended to "issuers" generally.

ability to obtain, considerable knowledge about the company to obviate the need for securities act protection.

However, not as easily rationalized are the registration-prospectus exemptions relating to trades with employees. Sections 19(1)10 and 58(1)(c) provide such exemptions, covering trades by a company of securities of its own issue with its employees or those of an affiliate who are not "induced to trade by expectation of employment or continued employment".[126] It may be that some employees are able to fend for themselves and thereby not need the protection of the securities statute, but it is difficult to accept the breadth of the present employee exemption in comparison with the objectives of the statute generally.[127]

bb. Exempt Securities

Section 19(2) of the Ontario Securities Act lists some thirteen types of securities which are exempt from the registration requirements and section 58(2)(a) exempts such securities from the prospectus requirements. One writer has explained and characterized the securities exempted by the following descriptions: "extremely stable; regulated under other legislation; where the buyers thereof are able to fend for themselves; where expediency for business or social reasons require exemption; or where it is impracticable for the securities to be regulated."[128]

Specifically the exempt securities relate to:

(i) various government and bank debt securities;
(ii) certificates or receipts of a trust company registered under The Loan and Trust Corporations Act issued for moneys received for guaranteed investment;
(iii) negotiable promissory notes or commercial paper maturing not more than one year from the date of issue if each such note or paper traded to an individual is not less than $50,000;
(iv) mortgages or other encumbrances, other than those contained in or secured by a bond or similar obligation in a trust deed or other instrument, if such mortgages or encumbrances are not offered for sale to the public except by a person registered under The Ontario Real Estate and Business Brokers Act;
(v) securities of indebtedness due under any conditional sales

126 *See* D. Johnston at 203.

127 The narrower view of employees not needing securities act protection is illustrated by SEC v. Ralston Purina Co., 346 U.S. 119 (1953), in which the Supreme Court held that some senior employees fell outside the definition of public because of their access to a greater amount of information; *see also* Ontario Securities Commission Disclosure Report ¶ 8.07; Lumley v. Broadway Coffee Co. Ltd., [1925] 2 D.L.R. 417 (Ont. C.A.).

128 D. Johnston at 223.

contract or other title retention contract for the acquisition of personal property if such securities are not offered for sale to the public;

(vi) securities issued by a person or company which

(1) is organized exclusively for educational, benevolent, fraternal, charitable, religious or recreational purposes and not for profit, where no part of the net earnings enure to the benefit of any securityholder,

(2) is a corporation operated on a cooperative basis as defined by Part V of The Ontario Corporations Act;

(vii) shares of a credit union within the meaning of The Credit Unions Act;

(viii) securities of a private company[129] issued by the private company if the securities are not offered for sale to the public;

(ix) securities sold by a prospector for the purpose of financing a prospecting expedition;

(x) securities issued by a prospecting syndicate which has complied with the filing and other requirements relating to such syndicates;[130] and

(xi) securities issued by a mining or mining exploration company as consideration for mining claims where the vendor enters into such escrow or pooling agreement as the Director considers necessary. [131]

Under section 58(2)(a), it is provided that section 35 does not apply to the distribution to the public of securities exempted by section 19(2) which are described above. A number of the above exemptions are based on the condition that the securities specified are not offered for sale to the public.[132] Thus the combined effect of section 58(2)(a) and these exempt securities is tautological: section 35 does not apply to an offer of securities to the public if securities are not offered to the public.[133]

v. *Denial of Registration Exemptions*

Subsections (5), (6), and (7) of section 19 deal with the power of the commission to order the denial of the registration exemp-

129 Defined in Ontario Securities Act, s. 1(1)14.

130 *See* s. 34 of the Ontario Securities Act calling for, *inter alia*, the filing of the prospecting syndicate agreement. Paragraph 11 of s. 19(2) exempts the securities of a prospecting syndicate where the securities are sold by the prospector who staked the claim and the prospector has delivered a copy of the prospecting syndicate agreement to the purchaser before accepting payment of the securities. Paragraph 12 of s. 19(2) requires that such securities must not be offered for sale to the public and not sold to more than 50 persons or companies.

131 In addition ¶ 13 of s. 19(2) specifies securities exempted by regulation.

132 Paragraphs 4 (mortgages), 5 (conditional sales), 9 (securities of a private company), and 12 (prospecting syndicates).

133 *See* Dey, *supra* note 74, at 165.

tions in subsections (1), (2), and (3) of section 19. Such an order may be made by the commission where in its opinion such action is in the public interest. The order will be directed at a named person or company. Subsection (6) provides that the order will not be made without a hearing unless in the opinion of the commission the length of time required for a hearing might be prejudicial to the public interest, in which event a temporary order will be made which expires fifteen days from the date of making the order. Subsection (7) provides that, if a temporary order is made, notice must be given of the order forthwith together with notice of the hearing required by section 5 of the act to every person or company that in the opinion of the commission is primarily affected thereby. It is interesting to note that the commission has used its power under section 19(5) where it appears that exemptions in the act are being used to contravene the spirit of the statute.[134]

C. SOME RECENT DEVELOPMENTS IN CANADIAN SECURITIES LEGISLATION

1. *Introduction*

Since the enactment of Ontario's Securities Act in 1966 following the recommendations of the *Kimber Report*, there have been a number of reports and legislative developments bearing directly or indirectly on the scope of the securities statutes. Most notable are the 1971 securities act amendments which are traceable to the report by a committee of the Ontario Securities Commission on matters involving the disclosure of information[135] and the *Canadian Mutual Fund Report* of 1969. Shortly after, Ontario introduced a basic overhaul of the Securities Act in its Bill 154, "The Securities Act, 1972",[136] which apparently was presented

134 *Id.* at 180-81. Dey discusses the decisions of the OSC; *see e.g. In re* Pyrotex Mining & Exploration Co. Ltd., [1968] OSC Bull. 115 (June) (promoters spending more money on stock promotion than mining development); *In re* Charter Oil Co. Ltd., [1968] OSC Bull. 243 (November) (company selling shares through TSE without a prospectus or statement of material facts); *In re* New Hosco Mines Ltd., [1968] OSC Bull. 259 (November) (failing to comply with TSE requests for disclosure of information); *In re* J.T. Blume, [1960] OSC Bull. 90 (May) (failure to comply with takeover bid provisions); *In re* Midgaul Investments Ltd., [1970] OSC Bull. 91 (June) (control group selling shares at a price much greater than contemplated by prospectus). For an example of applying s. 19(5) to corporate insiders who arguably contravened the insider trading liability sections of the Ontario Securities Act, *see In re* Harold P. Connor, [1976] OSC Bull. 149 (June).

135 Ontario Securities Commission Disclosure Report. For a review of the Report *see* Grover, Book Review, 23 Ad. L. Rev. 309 (1971).

136 *See* Ontario Bill 154.

after discussion with the other provinces.[137] Successor bills have been introduced[138] and at the time of writing a new statute has not been enacted. Also introduced are proposals to regulate franchises and commodity futures based, respectively, on the 1971 report of the committee on franchises appointed by the Minister of Financial and Consumer Affairs, and the 1975 *Report of the Interministerial Committee on Commodity Futures Trading.*[139]

Because of their relation to this study, the proposals relating to a revised securities act, franchises and commodity futures will be briefly discussed.

2. *Ontario's New Securities Act*

Bill 30, the Securities Act, 1977,[140] introduces fundamental changes to Ontario's securities legislation based primarily on the reports mentioned above.[141] Several of the innovations materially affect the scope of the legislation and the exemptions under the current statute.

a. *Definitions*

i. *Security*

Bill 30 has made several additions to the definition of a security under the heading "bond, debenture, note", etc. The words "or other evidence of indebtedness" have been added as have the words:

> "or any agreement under which the interest of the purchaser is valued for purposes of conversion or surrender by reference to the value of a proportionate interest in a specified portfolio of assets."[142]

The first change has been added to cover all debt obligations and the second to cover variable annuity contracts.[143]

Also added are documents constituting evidence of an agreement to grant an exclusive right to use real property for residen-

137 D. JOHNSTON at 17.

138 Ontario Bill 154 was followed by Bill 75, Bill 98, Bill 20 and Bill 30.

139 Also important have been the proposals of the ONTARIO SECURITIES COMMISSION DISCLOSURE REPORT and REPORT OF THE SELECT COMMITTEE ON COMPANY LAW OF THE ONTARIO LEGISLATURE ON MERGERS, AMALGAMATIONS AND CERTAIN RELATED MATTERS (1973) [hereinafter cited as SELECT COMMITTEE MERGER REPORT].

140 For a full discussion of a predecessor bill, *see* Dey, *Securities Reform in Ontario: The Securities Act, 1975*, 1 CAN. BUS. L.J. 20 (1975).

141 Principally the ONTARIO SECURITIES COMMISSION DISCLOSURE REPORT; the CANADIAN MUTUAL FUND REPORT; and the SELECT COMMITTEE MERGER REPORT, *supra* note 139.

142 Ontario Bill 30, s. 1(1)38.v.

143 *See* D. JOHNSTON at 29.

tial, recreational or vacation purposes on a time-sharing basis.[144] The definition of security in Bill 30 also specifically includes commodity futures options[145] and commodity futures contracts.[146]

ii. *Trade or Trading*

There are some important changes to the definition of trade or trading in Ontario Bill 30. The first heading of the definition of trade mentions that a sale or disposition of a security for valuable consideration is a trade, and goes on to provide expressly that trade or trading *does not include a purchase of a security.*[147] The present act refers to any sale or disposition or *other dealing or solicitation* in respect of a security, which, as mentioned above,[148] is arguably broad enough to include the purchase of a security. However, by the new language in Bill 30, a purchase is clearly excluded so that trades relate to sales only.

A specific item that is listed in Bill 30 as a trade or trading is any transfer, pledge, or encumbrancing of securities of an issuer from the holdings of any person or company, or combination of persons or companies, who are control persons for the purpose of giving collateral for *bona fide* debt. This definition makes it absolutely clear that a transfer or pledge or encumbrance by a control person of its shares is a trade, and, barring an exemption, the registration and disclosure requirements would have to be complied with.[149]

In the present act, the definition of trade includes an attempt to make a sale or dispose of a security or to deal or to make a solicitation in respect of a security. The "attempt" wording is taken out of Bill 30, but left in is the present language which provides that any act, advertisement, conduct, or negotiation directly or indirectly in furtherance of any of the foregoing illustrations of trade is also a trade. One addition is made to this list, providing that any "solicitation" in connection with any of the

144 Ontario Bill 30, s. 1(1)38.xv. Arguably this specific heading would be interpreted as coming within other headings of the definition of security, *e.g.* investment contract.

145 Commodity futures options within the meaning of the Commodity Futures Act, 1977, Bill 32, 31st Leg. Ont., 1st Sess., 1977 (1st reading) are included except those options traded on commodity futures exchanges registered or recognized by the commission under said act; Ontario Bill 30, s. 38(1)38.xvi. This will be discussed further in note 164 *infra.*

146 An exception is made for a commodity futures contract within the meaning of the Commodity Futures Act, 1977, in Ontario Bill 30, s. 38(1)38.xvii.

147 Ontario Bill 30, s. 1(1)40.i.

148 *See* the discussion in note 71 *supra.*

149 Ontario Bill 30, s. 1(1)40.iv; *see* the discussion on "Distribution" in ch. III.C.2.a.iii *infra.*

foregoing is also a trade.[150] This again confirms that the solicitation has to be in connection with the sale or disposition of a security rather than in connection with the purchase of a security.

iii. *Distribution*

The definition of distribution reflects probably the most significant change in the definitions of Bill 30 and the approach taken by the bill generally. Under the present act, distribution is used in connection with distributions to the public. The public concept is dropped from distribution and that term is now defined to mean:

(a) a trade in securities of an issuer that have not been previously issued,

(b) a trade by or on behalf of an issuer in previously issued securities of that issuer which have been redeemed or purchased by or donated to that issuer,

(c) a trade in previously issued securities of an issuer from the holdings of any person, company, or combination of persons or companies, holding a sufficient number of any securities of that issuer to affect materially the control of that issuer, but any holding of any person, company, or combination of persons holding more than 20% of the outstanding voting securities of an issuer shall, in the absence of evidence to the contrary, be deemed to affect materially the control of that issuer,

(d) a trade in securities previously issued through specified prospectus exemptions, and

(e) the first trade in previously issued securities of a company that has ceased to be a private company.

The present Ontario Securities Act treats sales of securities by control persons as distributions to the public, which require prospectus compliance. Bill 30 continues this treatment, but section 73(7) of the bill provides an exemption from the prospectus requirements (a) if the distribution involves specified exempt trades, (b) if the issuer is a reporting issuer which complies with prescribed requirements, and (c) no unusual effort to prepare the market or to create a demand for the securities is made or no extraordinary commission is paid. The prescribed requirements relating to the reporting issuer are that it must have been a reporting issuer, as that term is defined,[151] for at least eighteen

150 Ontario Bill 30, s. 1(1)40.v.

151 The definition of reporting issuer is wide enough to include companies which have distributed securities through a prospectus or takeover bid circular under the Ontario Securities Act or any predecessor thereof, or whose securities were listed for trading on a recognized stock exchange, or which are corporations offering securities to the public under the Ontario Business Corporations Act, or companies

months, and must not be in default with respect to any requirements under the act or regulations. In addition, the control person must file with the commission, and, if securities are listed, with the stock exchange, within a specified period prior to the proposed sale, information which includes a notice of intention to sell, and details about the control position and numbers of securities proposed to be sold and in what manner, as well as a declaration certifying that the control person or persons have no knowledge of any material change which has occurred in the affairs of the issuer which has not been generally disclosed, and no knowledge of any other material adverse information concerning the issuer. In addition, within three days after the completion of the sale the control person must file a report in prescribed form. The notice and declaration must be renewed sixty days after the original date of filing of the notice and declaration and every twenty-eight days thereafter, so long as any of the securities specified in the original notice have not been sold or until notice has been filed that the securities will not be sold. As has been noted, this complicated exemption allows the control person to dispose of all or a portion of his control bloc without having to qualify a prospectus or to obtain a section 59 order under the present act.[152]

With respect to secondary issues or trades in previously issued securities contemplated by the fourth paragraph of the definition of distribution (paragraph (d) above), Ontario Bill 30 takes a different approach from the treatment under the present act. Under the Ontario Securities Act, a trade in a security, even though issued, is a distribution to the public if the issued security is not previously distributed to the public and the trade in the security is made for the purpose of distributing to the public such security. Under the bill, the trade in an issued security can only be a distribution when the trade is the first trade in the security immediately after a trade pursuant to a section 73 exemption, which first trade is not made in compliance with the requirements for first trades in securities after being traded through a section 73 exemption.[153]

b. *Exemptions*

The exemptions from registration are set forth in part XI (sections 33–36) of Ontario Bill 30. Section 33 deals with exemp-

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continuing after an amalgamation or merger of companies where one of the companies included was a reporting issuer for at least twelve months; Ontario Bill 30, s. 1(1)36.

152 Dey, *supra* note 140, at 34.

153 This conclusion is reached by the combined effect of ss. 73(4), (5), (6), (7).

tions from registration as an adviser and is basically similar to section 18 of the present act. Section 34 deals with those exemptions which are occasioned by the regulation of mutual funds. Section 35 of Bill 30 deals with the general registration exemptions and corresponds with section 19 of the present act, although it contains numerous improvements over the wording of the present act. For example, the isolated trade exemption in Bill 30 is stated to apply not only to an owner of a security, but also to the issuer, if the trade is for the issuer's account.[154] The agency trade exemption is extended to orders placed with a bank to which the Bank Act applies or a trust company registered under the Ontario Loan and Trust Corporations Act if the purchase is made through an agent who is a registered dealer.[155] A new exemption arising from commodity futures regulation is found in section 35(1)18 which exempts a trade in a commodity futures option or contract where such trade is a *bona fide* hedging transaction within the meaning of the Commodity Futures Act, 1977, as is discussed below.

A most important exemption is in paragraph 17 of section 35(1) which deals with an exempt trade between an issuer and not more than twenty-five purchasers or between such purchasers, if each of the specified requirements is met. These are:

(1) each purchaser purchases as principal;
(2) each purchaser
    (a) is an investor who, by virtue of his net worth and investment experience, or by virtue of consultation with or advice from a registered adviser, is able to evaluate the prospective investment on the basis of information respecting the investment presented to him by the issuer, or has access to substantially the same information concerning the issuer which the filing of a prospectus under this Act would provide; or
    (b) is a senior officer or director of the issuer or his spouse, parent, brother, sister, or child;
(3) the offer and sale of the securities are not accompanied by an advertisement and no selling or promotional expenses have been paid or incurred in connection therewith, except for professional services or for services performed by a registered dealer;
(4) solicitations in respect of the securities have not been made to more than 50 prospective purchasers; and

154 Ontario Bill 30, s. 35(1)2.

155 Ontario Bill 30, s. 35(1)10. Improvements are also made in the issuers' trades exemptions in ¶ 11 of s. 35(1) and the business combination exemptions in ¶¶ 12 to 15 of s. 35(1).

(5) there are not more than 25 beneficial owners of securities as a result of trades pursuant to this exemption.

This is the limited offering exemption and the various requirements, including the arbitrary twenty-five limit, replace the concept of "public" in the present act. In effect paragraph 17 defines what will be considered as not trading with the public for exemption purposes.

Section 35(2) deals with exempt securities and there are some changes from the present act. In paragraph 2 of subsection (2), contracts of insurance issued by an insurance company licensed under the Ontario Insurance Act, other than variable contracts that do not guarantee to return on the termination of the policy an amount equal to at least three-quarters of the payment paid to the date of termination, are exempt securities. Also exempted are securities issued by a trust company registered under the Loan and Trust Corporations Act in respect of an account maintained by the company solely to service a retirement savings plan registered under the Canada Income Tax Act, or a common trust fund as defined by the Ontario Loan and Trust Corporations Act, or a pooled account for facilitating investment.[156] Again, this exemption recognizes the special types of securities with respect to corporations already regulated by the Ontario Loan and Trust Corporations Act. Securities issued by an investment club are another example of exempt securities, if the club's shares or units are not held by more than fifty persons, it does not pay or give any remuneration under a management contractor in respect of a trade of securities except normal brokerage fees, and all of its members are required to make contributions in proportion to the shares or units each holds for the purpose of investment.

Some of the securities exemptions under the present Ontario act which are conditional on their not being offered for sale to the public are changed in section 35 to eliminate the public concept. For example, securities evidencing indebtedness under a conditional sales contract are exempt as long as they are not offered for sale to an *individual*.[157] However, securities of a private company are exempt provided they are not offered for sale to the public.[158]

The prospectus exemptions are in part XVI of Ontario Bill 30 (sections 73–75) and have become extremely complicated because Bill 30 treats every issue as a distribution and thereby subject to prospectus requirements and then proceeds to specify exempt trades in section 73, exempt securities in section 74, and then a

156 Ontario Bill 30, s. 35(1)4.

157 Ontario Bill 30, s. 35(1)8.

158 Ontario Bill 30, s. 35(1)12. This is one of the few instances where the word "public" appears in Bill 30.

familiar provision, reminiscent of present sections 20 and 59, section 75 under which an application can be made to the commission for exemption from the registration and prospectus requirements.

As previously mentioned, the only situation under Bill 30 where a trade in an issued security can be a distribution is where the trade is the first trade in a security immediately following a trade pursuant to a section 73 exemption, which first trade is not made in compliance with the requirements for a first trade in securities after being traded pursuant to a section 73 exemption. These requirements are specified in subsections (4), (5), and (6) of section 73 and generally require that the issuer is a reporting issuer not in default of any requirement of the act or regulations, the securities have been held for specified periods and no unusual effort is made to make a market and no extraordinary consideration is paid for the trade.[159] This is part of the continuous disclosure approach of Bill 30 which makes it possible to avoid the concept of the public and to reduce the number of situations in which application to the commission for a specific exemption is necessary as is the case under section 59 of the present act.

Section 73 continues many of the trades in the present Ontario Securities Act which are exempt from the prospectus requirements, albeit with certain modifications.[160] The most important change in the prospectus exemptions is that provided by section 73(1)m dealing with the limited offering exemption, which corresponds with the limited offering registration exemption found in section 35(1)17 discussed above.[161]

Section 74 exempts certain securities from the prospectus requirements. First to be exempted are those securities specifically made exempt from registration by section 35(2) with the exceptions of securities issued by a mining company as consideration for mining claims, and securities in respect of which the regulations provide registration is not required.[162] Securities also exempted from the prospectus requirements are those for which a statement of material facts is accepted for filing by a recognized stock exchange and the commission. The third exemption relates to options to sell or purchase securities known as puts and calls or any combination thereof which provide that the holder may sell to or

159 Subsection (6) of s. 73 provides that the first trade in securities purchased under the underwriter exemption in s. 73(1)(o) is a distribution.

160 It is interesting that the isolated trade exemption where it relates to a trade by or on behalf of an issuer for its account is now found in the prospectus exemptions; Ontario Bill 30, s. 73(1)(b).

161 For a discussion of those conditions, *see* Dey, *supra* note 140, at 24-25.

162 Ontario Bill 30, s. 74(1)(a).

purchase from the writer of the option the specified amount of securities at a specific price and subject to other conditions, provided that (i) the option has been written by a member of an exchange recognized by the commission for this purpose or the performance under the option is guaranteed by a member of an exchange recognized by the commission for this purpose, (ii) the securities that are subject to the option are listed and posted for trading on an exchange recognized by the commission for this purpose, and (iii) the option is in the form from time to time prescribed by the regulations. This exemption relates to the fact that the commission has permitted options of the Chicago Board Options Exchange to be traded by members of the Toronto Stock Exchange.[163]

3. *Commodity Futures*

a. *Report of the Interministerial Committee on Commodity Futures Trading*[164]

i. *Background to the Report*

Trading in commodity futures contracts and variations thereof has been largely unregulated in Canada. As will be seen in the next section of this paper, there have been certain types of agreements involving a commodity which have been held to be securities by securities administrators and the courts, but there has been a reluctance to interpret "trading" and "security" within the Securities Act to embrace commodity contracts.[165] Recently the Ontario Minister of Consumer and Commercial Relations, acting on a recommendation of the Ontario Securities Commission, proposed an interministerial study of commodity contracts and, accordingly, a committee was set up with representatives from the following departments: Attorney-General; Agriculture and Food; Treasury, Economics and Intergovernmental Affairs; Natural Resources; and Consumer and Commercial Relations. The purpose of the study was to establish the appropriate regulatory mechanisms to control and regulate trading in commodity futures in Ontario in order to protect the customers of commodity futures brokers and to determine the desirability of encouraging estab-

163 In fact the regulation was passed pursuant to s. 58(2)(d) of the Ontario Securities Act; *see* Ontario Securities Regulations, s. 86. *See also* forms 30, 31 relating thereto.

164 Report of the Interministerial Committee on Commodity Futures Trading (1975) [hereinafter cited as Commodities Report].

165 *Id.* at 1. As the Commodities Report mentions, although there are similarities between securities and commodity futures contracts, there are substantial differences and the regulatory tools and techniques for investors in securities are not fully appropriate for commodity contracts; *id.*

lishment of an exchange for trading in commodity futures contracts in Ontario.

The scope of the study was extremely wide, covering all commodities in which futures were to be traded, such as agricultural products, minerals, petroleum and its by-products, forest products, and metals, and any other personal property whose futures can be traded. The study also was to focus on the question of licensing brokers and their salesmen dealing in commodity futures contracts. The feasibility of establishing an Ontario exchange was also to be investigated, and the nature and extent of possible federal participation in such an exchange.[166] Regulatory practices in other jurisdictions, such as New York, California, Wisconsin and the U.S. federal level, were to be reviewed, as well as the questions of a proper agency for administration and supervision and of continuing to allow registered security dealers to trade in futures.

ii. *The Major Recommendations*

The recommendations of the *Commodities Report* are of considerable importance to the question of security regulation. The report dealt with three specific topics in its conclusions and recommendations: commodity futures contracts, the marketplace, and the participants.

The study recommended that the participants be licensed and felt this was extremely important in order to protect the small speculator in the commodity futures market. The committee reviewed regulatory schemes in other jurisdictions, and its recommendations were based on the elements they thought were most appropriate for Ontario. With respect to the marketplace, the study anticipated that proposed legislation would have a regulatory framework within which an exchange could be established and supervised in Ontario. The commodity exchange under the legislation would have to comply with general government policies on self-regulatory bodies, for example, similar to the Toronto Stock Exchange.[167]

The study acknowledged that the distinction between those types of contracts which are more appropriately regulated as securities and those which should be the subject of commodities legislation is not easy to draw. The recommendation of the report is that, where the contract is a commodity futures contract or a

166 Relevant to federal involvement is the Grain Futures Act of 1939, R.S.C. 1970, c. G-17, which regulates futures trading in certain grains on the Winnipeg Commodity Exchange through the Canadian Grain Commission; *see* COMMODITIES REPORT, *supra* note 164, at 69-77.

167 *Id.* at 79-80.

commodity futures option traded on an established exchange and carrying the collateral guarantee of a clearinghouse, it clearly falls within the scope of the proposed commodities legislation as being the type of contract for which the regulatory tools and techniques designed for the protection of investors in securities are not wholly suitable. On the other hand, contracts that were felt to be of the nature of investment contracts, where the investor is directly at risk with the grantor or writer of a contract, should be governed under the Ontario Securities Act.

> "These are: a) commodity futures options not guaranteed by the clearinghouse of an established exchange and those commodity futures options not 'accepted' for trading under the proposed new legislation; b) coin-dealers' margin account contracts and their like; c) options on physical commodities offered to other than producers, dealers, or users of the particular commodity."[168]

The study went on to say that these issuers would have to file a prospectus under the Ontario Securities Act and comply with all the other requirements of the act. In addition, the definition of security in the Ontario Securities Act would have to be amended specifically to encompass all of the commodity-related contracts suggested above.

The *Commodities Report* also said that the definition exemptions in the proposed commodities legislation and in the Ontario Securities Act should be framed to exclude for greater certainty and clarity *bona fide* hedging transactions through commodity futures contracts, commodity futures options and commodity options, all spot commodity transactions and forward contracts entered into by *bona fide* hedgers.[169]

In addition, trading in certain options would be prohibited on the ground that they are without any utility and have been demonstrated to be probable vehicles for fraud. Examples of these are options to buy commodities (calls), unless their performance is guaranteed by a recognized "commodity exchange or clearinghouse or the option grantor has a demonstrated present and continuing ability to meet the obligation to deliver the physical commodities called for under the contract". Similarly, options to sell commodities (puts) would be prohibited unless their performances were guaranteed or they were written by a viable option grantor. In short, the study concluded that, except for *bona fide* hedging transactions, only those commodity futures contracts, (a) traded on a commodity exchange, recognized by the regulatory

168 *Id.* at 81.
169 *Id.* at 82.

authority responsible for administration of the proposed new legislation, and (b) accepted by that regulatory authority, would be permitted to be traded in Ontario. Also, recognition of a commodity exchange would mean that the commodity futures contracts traded on its floor carried the collateral guarantee of a clearinghouse.[170]

In other words, it is a condition precedent that the commodity futures contract underlying the option must first be "accepted". If acceptance is not obtained, trading in the commodity futures options, except for *bona fide* hedging transactions, would not be permitted in Ontario, except as a security under the Securities Act. The definition of security in the Securities Act should be amended to reflect this position.[171] This would mean that commodity futures options could not be publicly traded without a prospectus filed under that act.

The committee also recommended, instead of setting up a new bureaucracy, that the Ontario Securities Commission should be responsible for supervising the regulatory scheme and administering the new legislation.[172] However, it did recommend that a commissioner be added who would have experience in the commodity and related fields.[173] Moreover, at the administrative level, an individual would be designated Deputy Director, Commodity Futures Regulation.[174] It would be expected that this person would give guidance and direction to the registration and surveillance program and have overall responsibility for the initial registration program.[175] It is also interesting to note that the commission would have available for consultation a body which was to be known as the Commodity Futures Advisory Board with a role similar to that of the Financial Disclosure Advisory Board that the commission has available as its adviser on financial disclosure matters under the Ontario Securities Act.[176] The Commodity Board would consist of five members with varying experience in the field and would be appointed by the Lieutenant Governor in Council to advise the Ontario Securities Commission on matters

170 *Id.* at 83.

171 *See* Ontario Bill 30, ss. 1(1)38.xvi, xvii; *but* ss. 35(1)18 and 73(1)(p) exempt from the registration and prospectus requirements commodity futures options or commodity futures contracts which are *bona fide* hedging transactions within the meaning of the Commodity Futures Act, 1977, which is discussed *infra*.

172 COMMODITIES REPORT, *supra* note 164, at 85.

173 *Id.* at 85-86.

174 *Id.* at 86.

175 *Id*

176 *Id.* at 87.

of policy and planning as well as on specific questions referred to it by the commission.[177]

b. *Bill 32, The Commodity Futures Act, 1977*

Bill 32, The Commodity Futures Act, 1977,[178] reflects the major recommendations of the *Commodities Report*. As such, Bill 32 stipulates that the OSC[179] is charged with regulating trading in commodity futures contracts and commodity futures options except *bona fide* hedging transactions as defined.[180] Persons acting as dealers or advisers in commodity futures contracts or options must be registered.[181] Exemptions from registration are provided for *bona fide* hedging transactions, trades in commodity futures contracts or options by persons acting solely through agents who are registered dealers, and trades in commodity futures options for which a preliminary prospectus and prospectus have been filed and receipts therefore obtained under the Securities Act.[182] The last exemption confirms that commodity futures contracts or options other than *bona fide* hedging transactions will be regulated either under the Commodity Futures Act or the Securities Act.

Regulatory requirements relating to commodity futures exchanges and recognition of such exchanges by the commission are also provided.[183] Trading rules covering such matters as customers' statements, margin requirements, confirmation of trades, and various trade practices are specified with wide enforcement and regulation-making powers given to the commission and Lieutenant Governor in Council, respectively.

4. *Franchises*

As will be discussed in the next section, franchise arrangements have been held to be securities under the securities statutes. Based on U.S. legislation, notably the California statute, Alberta

177 *Id.* at 87-88.

178 Bill 32, 31st Leg. Ont., 1st Sess., 1977 (1st reading).

179 Section 2 of Bill 32, *id.*, sets up the Commodity Futures Advisory Board to consult with and advise the commission on commodities futures matters. Section 3 of Bill 32 empowers the commission to appoint experts to assist it.

180 *Id.* s. 1.2 defines the term to cover those purchases or sales of commodities contracts for the *bona fide* purpose of offsetting price risks incidental to commodity dealings which are necessary to the hedger's business activities. Such hedging transactions are not regulated either under the Ontario Commodity Futures Act or the Ontario Securities Act.

181 *Id.* ss. 22-30.

182 *Id.* s. 32.

183 *Id.* ss. 33-40.

passed its Franchises Act in 1971.[184] The Ontario Minister of Financial and Commercial Affairs appointed a committee to study franchises and the committee submitted its report in 1971 recommending legislation similar to that of Alberta.[185]

Although the Alberta statute has a very wide definition of franchise,[186] it does not require franchisors to register; but it requires qualifying a prospectus before concluding a franchise agreement. Under proposed Ontario legislation, we are told that the statute will require registration which may be withheld at the discretion of the OSC if the "franchisor is not honest and of good repute and integrity".[187] Commenting on the blue sky theme, one writer anticipates that the approval of the prospectus will be based on the "fair, just and equitable" standard and that there will have to exist a reasonably equal bargaining relationship between the franchisor and franchisee.[188]

Chapter IV
Interpretations of "Security" under U.S. Legislation

A. INTRODUCTION

Probably no term in securities legislation has received more interpretation and comment than "security". Securities promoters, administrators, practitioners and the courts have combined their efforts to produce a surprisingly large body of cases and commentary on the meaning of security under U.S. federal and state legislation. Indeed the decisions are so numerous that a separate treatise could be written about them.[189]

This section of the paper will touch on some of the federal and state decisions under headings which have been chosen primarily for purposes of discussion: first, some major U.S. Supreme Court and state court decisions, and next, the special transactions or arrangements that have given rise to judicial and administrative

184 Alberta Franchises Act, S.A. 1971, c. 38.

185 Ontario Dept. of Financial and Commercial Affairs, REPORT OF THE MINISTER'S COMMITTEE ON REFERRAL SALES, MULTI-LEVEL SALES AND FRANCHISES (1970) [hereinafter cited as the GRANGE REPORT].

186 *See* Alberta Franchises Act, S.A. 1971, c. 38, s. 1(1)6, which excludes arrangements between manufacturers or where the franchisor is the Crown, a Crown agency or a municipal corporation.

187 *See* D. JOHNSTON at 33.

188 *Id.* Johnston also states that unacceptable advertising literature of the franchisor or a lack of appropriate provisions for arbitration of disputes will be grounds to refuse a prospectus; *id.*

189 A useful collection of the vast number of decisions is found in BLUE SKY NEWS, October–December 1977, where some 50 pages of the issue are devoted to listing decisions interpreting security under U.S. federal or state law.

interpretation. These have been classified under various categories – again, for purposes of discussion only.

At the outset it should be mentioned that much of the litigation has centred around the meaning of the investment contract branch of the definition of security which, as previously stated,[190] has been a separate ingredient of the definition for some time. In fact, the investment contract phrase has permitted the courts and administrators to keep up with the fertility of invention of promoters of schemes and arrangements designed to avoid the impact of securities legislation.

B. U.S. SUPREME COURT DECISIONS

The first decision of the U.S. Supreme Court interpreting investment contract was *SEC v. C.M. Joiner Leasing Corp.*[191] In this case, the defendants offered to sell oil leases and represented that they would drill a test well which would indicate the productivity of the acreage to be sold to the lessee. The defendants argued that this was merely the offer of leasehold rights.

Justice Jackson stated:

> "It is clear that an economic interest in this well-drilling undertaking was what brought into being the instruments that the defendants were selling and gave to the instruments most of the value and all of their lure. Trading in these documents had all the evils inherent in the security transactions which it was the aim of the Securities Act to end."[192]

In reversing the lower court, he preferred to adopt a case-by-case analysis rejecting any attempt to define investment contract by a specific verbal formula:

> "The test rather is what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect. In the enforcement of an Act such as this, it is not inappropriate that promoters' offerings be judged as being what they were represented to be."[193]

One of the most important and oft-cited cases decided by the Supreme Court on the definition of investment contract is that of *SEC v. W.J. Howey Co.*[194] The arrangements in question involved the sale of citrus acreage accompanied by an option to purchase

190 *See* text accompanying note 9 *supra*.
191 320 U.S. 344 (1943).
192 *Id.* at 348.
193 *Id.* at 352-53.
194 328 U.S. 293 (1946).

service contracts that would require an affiliated corporation of the vendor to cultivate and market the fruit. It was impractical for the purchasers to participate in developing their own land because they would not, among other things, have the necessary sophistication. Justice Murphy, unlike Justice Jackson in *Joiner*, was very willing to enunciate a general test of investment contract which he said he discerned from the state decisions on the question.[194a] In so doing, he noted that the U.S. Congress in enacting the federal legislation was influenced by the state securities laws. The test enunciated by Justice Murphy was:

> "An investment contract for the purposes of a securities act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed by the enterprise."[195]

Although the decision has been criticized insofar as it purported to rely on prior cases erroneously,[196] the case is referred to in nearly all the subsequent decisions, particularly the test advanced by Justice Murphy. In fact the test, which the Court stated was a flexible rather than static one, adaptable to meet countless new schemes to attract money, has itself come under microscopic analysis. The emphasis is now on defining "investment contract" as opposed to "security".

In *SEC v. The Variable Annuity Life Insurance Company of America*[197] the U.S. Supreme Court, by a five-to-four majority, held that the insurance exemptions in section 3(a)(8) of the Securities Act of 1933, which exempts conventional life insurance annuity contracts, were not applicable to a variable annuity with the result that these contracts had to be registered under the Securities Act of 1933. The Court acknowledged that variable annuity contracts have many features similar to those of customary insurance, for example, that the payments on both are made periodically and continue until the annuitant's death or some other fixed time,[198] but the Court felt that variable contracts are distinguishable because they guarantee no fixed monthly or yearly amount.

Justice Douglas emphasized the importance of the allocation

194a Notably State v. Gopher Tire & Rubber Co., 177 N.W. 937 (Minn. 1920).

195 328 U.S. at 298-99.

196 *See e.g.* Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135, 177 (1971).

197 359 U.S. 65 (1959).

198 *Id.* at 70.

of risk, which he thought was the factor on which the issue turned. In his view the holder of a variable annuity got only a *pro rata* share of what the portfolio of the equity interest reflected. Thus, all of the investment risk was placed on the annuitant, and not on the company, whereas in insurance there is some investment risk-taking on the part of the insurer.[199] Justice Brennan, in concurring, stated that the situation changes where

> "the coin of the company's obligation is not money but is rather the present condition of its investment portfolio. ... Prescribed limitations on investment and examination of solvency of reserves become perfectly circular to the extent that there is no obligation to pay except in terms measured by one's portfolio.... Where the nature of the obligation assumed is such, the federally protected interests in disclosure to the investor of the nature of the corporation to whom he is asked to entrust his money and the purposes for which it is to be used become obvious and real. The contract between the investor and the organization no longer squares with the sort of contract in regard to which Congress in 1933 thought its 'disclosure' statute was unnecessary."[200]

The risk analysis of Justice Douglas and the policy comments of Justice Brennan were developed further in *SEC v. United Benefit Life Insurance Company*.[201] Again, the question was whether or not annuities, which were called "flexible fund annuities", were exempt under section 3(a)(8) of the 1933 act. The contracts were similar to the variable annuities in the prior Supreme Court decision, in that the purchaser's premiums were invested in the defendant's managed funds. However, whereas in the prior case there was no fixed return, in *United Benefit* the defendants guaranteed a minimum cash value which ranged from 50% of net premiums in the first year to 100% after ten years. Thus the issue was how much risk must the insurer assume to qualify for the exemption contained in section 3(a)(8) of the 1933 act. The Court stated that there was still, despite the defendant's guarantee, a substantial part of the investment risk remaining with the policyholder and not the insurer. Thus the *Variable Annuity* and *United Benefit Life* cases emphasized the risk to the investor. Even though the two cases are limited to determining the breadth of the insurance exemption, it has been suggested that the risk allocation emphasis is sensible since it means that where there is a scheme

199 *Id.* at 71.
200 *Id.* at 78.
201 387 U.S. 202 (1967).

designed to shift substantially all of the investment risk to the purchaser, public policy weighs heavily in favour of disclosure of these material facts.[201a]

In *Tcherepnin v. Knight*,[202] the U.S. Supreme Court held that the withdrawal of capital shares in an Illinois savings and loan association fell within the definition of an investment contract (and other definitional branches of security) under the Securities Exchange Act of 1934. The Court based its decision on policy considerations:

> "[W]e are guided by the familiar canon of statutory construction that remedial legislation should be construed broadly to effectuate its purposes. The Securities Exchange Act quite clearly falls into the category of remedial legislation. One of its central purposes is to protect investors through the requirement of full disclosure by issuers of securities.... In searching for the meaning and scope of the word 'security' in the Act, form should be disregarded for substance and the emphasis should be on economic reality."[203]

The decision has been succinctly summarized as follows:

> "The Court appears to be saying unanimously: (1) do not ignore the other definitional pegs in analyzing securities transactions; (2) the legislative history of the 1933 and 1934 Acts may be read together to afford broad coverage in the definition of the term security; and (3) with an eye toward federal policy, look to substantive economic realities to determine as a matter of federal law whether these realities constitute a security."[204]

In its most recent decision on security, *United Housing Foundation v. Forman*,[205] the United States Supreme Court applied the substance-over-form principle from *Tcherepnin v. Knight* and reasserted the *Howey* test to exclude a financing device from the requirements of the federal securities statutes. In the case, purchasers of certain stock were granted options to lease apartments in a subsidized nonprofit housing cooperative in New York City. Each purchaser was obligated to buy eighteen shares of "stock"

201a Hannan & Thomas, *supra* note 11, at 228.

202 389 U.S. 332 (1967). The decision is also noteworthy in that the Supreme Court discussed other definitional headings of "security", namely, "certificates of interest or participation in any profit sharing agreement", "stock", "transferable shares" and "instruments commonly known as 'security' " under the Securities Exchange Act of 1934; *id.* at 339-40. In addition, the omission of the term "evidence of indebtedness" from the 1934 act was not thought to be significant by the Court.

203 389 U.S. at 336.

204 Hannan & Thomas, *supra* note 11, at 229.

205 421 U.S. 837 (1975).

for each apartment room at a cost of $25 per share or a total cost per room of $450. An information bulletin issued prior to construction of the cooperative predicted that the average monthly rental cost would be about $23 a room; however, because of increased costs in construction the average monthly rental charge rose to about $40 a room. Some tenants filed a class action under federal and state securities provisions seeking in excess of $30 million in damages, forced rental reductions and other appropriate relief alleging misrepresentation through the information bulletin. Thus the action turned on whether a security was involved.

The U.S. Court of Appeals for the Second Circuit reversed the trial court and held that the shares in the cooperative were "investment contracts" and that the use of the word "stock" required that a literal approach be used to include the arrangement as a security.[206] The U.S. Supreme Court, in looking at the economic realities of the situation, reversed this holding, stating that close examination of the disputed transaction disclosed none of the characteristics traditionally associated with stocks (such as dividends, voting, alienation rights) despite their being called that. Moreover, the shares in the cooperative were not investment contracts because the inducement to purchase was solely to acquire subsidized low-cost living space and not to invest for profit.[207]

The Court noted that profit for the investment contract definition means either capital appreciation of the initial investment or a participation in earnings resulting from the use of the investor's funds. The profit expectation in terms of capital appreciation was absent, since the purchasers of the apartments were required to offer them back to the defendant at the purchase price. Also, with respect to participation in earnings, the Court of Appeals had ascertained three separate grounds for profit expectation: (1) the deductibility for tax purposes of the shareholder's payments made for real estate taxes and interest; (2) the offering of an apartment at a cost below the rental charge for comparable housing as a profit to the stockholders, and (3) the possibility of income resulting from commercial facilities established for the convenience of apartment residents. The Supreme Court, however, disagreed with the Court of Appeals on its conclusions in this respect.

The Supreme Court said that the deductibility of interest is simply a tax benefit available to any homeowner, and to equate a deduction which merely results in a reduction in taxable income with an expectation of profit is pure sophistry. The Court also said

206 500 F.2d 1246 (2d Cir. 1974).
207 421 U.S. at 851.

that the offering of an apartment at a cost below the rental charge for comparable housing was merely a state-supported financial subsidy. Because its welfare benefits cannot be liquidated into cash, the real estate had no connection with the expectation or production of profits or reliance on the managerial efforts of others. Finally, on the possibility of income from commercial enterprises in the project, there was no evidence to indicate that the return from these enterprises exceeded the expenses incurred in providing the rental space. The possibility of income from this source was rejected as "too speculative and insubstantial". In fact, the Court said that the true rationale of the commercial enterprise involvement was not to produce profit for the tenants but to provide essential services to the residents, thereby making the complex a more attractive housing facility. In short, the Court concluded that there was no hope of receiving profits from the efforts of others because what was involved was the purchase of living quarters for personal use.[208]

What is to some attractive about the Court's reasoning is that it illustrates substance over form to *exclude* securities jurisdiction. What is attractive about the result is keeping federal securities legislation out of local subsidized residential accommodation plans. On the other hand, both reasoning and result have been criticized as leading to undesirable consequences.[209]

C. SOME MAJOR STATE COURT DECISIONS: HEREIN THE RISK CAPITAL AND RELATED TESTS

In looking at decisions of state courts, it should be kept in mind that, although many of the state statutes have definitions of security similar to those in the federal securities statutes, the objectives and approach of the state securities acts are fundamentally different. As previously mentioned, the state legislatures adopted the blue sky philosophy which resulted in a merit standard involving fairness and equity being applied to the issuing of securities. On the other hand, the federal objectives were aimed at

208 The Court also held there was no distinction between an investment contract and "an instrument commonly known as a security"; *id.* at 852.

209 *See* the discussion of the case in Comment, *What Is a Security?*, [1974] Wash. U.L.Q. 815, 852-54. As mentioned therein, the U.S. Supreme Court was too conservative in its concept of profit and should have focused on the valuable benefit received. Moreover, on a policy level, the article states that the scheme in *Forman* is capable of abuse such that the anti-fraud measures of the securities acts are an appropriate remedy. For a recent decision subsequent to *Forman*, *see* Grenader v. Spitz, 537 F.2d 612 (2d Cir. 1976), *cert. denied*, 97 S. Ct. 541 (1976). *See also* Guard, *Shares in Privately Financed Cooperative Apartment Corporations and the Federal Securities Laws after Grenader v. Spitz*, 30 RUTGERS L. REV. 433 (1977).

full disclosure of information and prevention of fraudulent practices in security trading without regulating the appropriateness of the security for public sale. This difference in objectives and approach can account for a correspondingly different interpretation of the term "security" for the purposes of the state or federal statute involved.[210]

One of the early state decisions interpreting the term "investment contract" was *State v. Gopher Tire & Rubber Co.*[211] In that case, the defendant sold certificates to investors who paid $50 for them and agreed to help "by word of mouth and in other ways" in the sale of tires and tubes manufactured by the defendant in exchange for a percentage of the price of goods sold by the defendant's representative in a designated area for some twenty years. With no precedent to refer to, the court turned to the dictionary meaning of the words concerned to hold that the arrangement was a security. The court defined investment as:

> "The placing of capital or laying out of money in a way intended to secure income or profit from its employment is an 'investment' as that word is commonly used and understood."[212]

The court in very expansive language also stated:

> "If the defendant issued and sold its certificates to purchasers who paid their money justly expecting to receive an income or profit from the investment, it would seem that the statute should apply."[213]

This broad view of investment could include any contract with investment overtones and could bring within the securities statutes, for example, contracts to purchase real estate or commodities.[214] Nonetheless the broad range of the definition has been adopted by state legislatures and other decisions of state courts.[215]

The most celebrated departure from the federal test enunciated by the U.S. Supreme Court in *Howey* is the decision of the Supreme Court of California in *Silver Hills Country Club v. Sobieski*.[216] In *Silver Hills*, the promoters contracted to buy a ranch for $75,000, putting only $400 down as a deposit, with the rest of the purchase price to come from the sale of memberships in a

210 Long, *supra* note 5, at 102–03.

211 177 N.W. 937 (Minn. 1920).

212 *Id.* at 938.

213 *Id.*

214 *See* Long, *supra* note 5, at 103–04.

215 It is interesting that, in a recent Minnesota case, the court reaffirmed its decision in State v. Gopher Tire & Rubber Co. and rejected the Howey definition of investment contract; *see* State v. Investor Sec. Corp., 209 N.W. 2d 405 (Minn. 1973).

216 55 Cal. 2d 811, 361 P.2d 906 (1961). The definition of security in the California Corporations Securities Code is similar to that found in the Securities Act of 1933.

country club to be constructed on the ranch. A membership was to include rights revocable only for misbehavior or failure to pay the dues. The California Commissioner of Corporations, John Sobieski, in realizing that the risk of loss was to rest almost exclusively on the public, issued a desist and refrain order pursuant to the provision of the California Corporations Securities Code which empowers the commission to make such an order when the sale of securities would be "unfair, unjust or inequitable". The plaintiffs sought judicial review arguing that the memberships were not securities because they conveyed no rights in the assets or income of the club, and because they were purchased not as an investment but for the personal enjoyment of the purchasers. In other words, although the purchasers were passively relying on the efforts of the promoters, there was no expectation of profit but merely the right to use the club facilities.

The court held that the memberships were securities, even though the members were not to participate in the club's profits, and said nothing like the ordinary sale of a right to use existing facilities was involved. The promoters solicited "the risk capital with which to develop a business for profit".[217] As has been pointed out, although there is some language in the opinion which suggests that the blue sky policy of "fair, just, and equitable" regulation was a factor in the court's decision, its reasoning was based primarily on the functional similarity of the solicitation of capital for new ventures, whether through an offering of stock or membership in a club.[218]

Justice Traynor found that the membership fell within the literal definition of a "beneficial interest and title to property", but also concluded that the scheme fell within the regulatory purpose of the statute. He stated:

> "[The objective of the corporate securities code] is to afford those who risk their capital at least a fair chance of realizing their objectives in legitimate ventures whether or not they expect a return on their capital in one form or another."[219]

The novel aspects of the statement are the expectation of the non-material benefit and the concept of risk capital. The emphasis on the regulatory purpose of the blue sky law allowed the court to feel more comfortable in relaxing the traditional requirement that investment contracts contain an element of monetary return.

217 55 Cal. 2d at 815.

218 Comment, *supra* note 209, at 822. For a helpful article on club memberships and securities, *see* Regan, *Securities Regulations: When Is a Club Membership a Security?*, 10 Loy. L.A.L. Rev. 356 (1977).

219 55 Cal. 2d at 815.

In this respect, the court pointed to the language of the California statute which includes non-interest-bearing notes or other evidence of indebtedness of nonprofit corporations within the definition of a security:

> "[The Code] extends even to transactions where capital is placed without expectation of any material benefits. Thus, from its exemption of securities of certain nonprofit companies, the [Code] specifically excepts 'notes, bonds, debentures, or other evidence of indebtedness, whether interest-bearing or not'."[220]

What is especially noteworthy about *Silver Hills* is that even in the absence of a profit motive, the promoter who seeks to finance his operation by the public solicitation of risk capital will be involved in security transactions. The presence of a profit motive on the part of the investors, of course, is a strong indication of a security as enunciated in fact in the *Howey* test. On the other hand, as the California court held, a promotional scheme should not escape the coverage of the securities statute merely because there was no profit motive on the part of the investor. The country club in *Silver Hills* was to be a profit-making venture for the promoters with the venture to be financed by using money obtained from the public, just as was done with respect to the citrus groves in *Howey* and the oil leases in *Joiner*.[221]

The approach of the *Silver Hills* decision has been called the "risk capital" test after the words used by Justice Traynor. The decision has been heralded as the first major attempt to avoid the mechanical use of the *Howey* test and to use an analysis emphasizing the economic and policy realities behind the transaction.[222] Other commentators have said that the *Howey* and *Silver Hills* decisions are reconcilable and indeed are complementary because they focus on different factors: the former emphasizing profit from investment, the latter emphasizing risk to the investor.[223] A major difficulty with *Silver Hills* is that the court did not sufficiently explain what risk capital means and thus introduced another subjective term in an attempt to provide an alternative to the definition of investment contract enunciated in *Howey*. It is interesting that in its most recent decision on security, *United Housing Foundation v. Forman*,[224] the U.S. Supreme Court did not accept the risk capital analysis for federal securities law. Without

220 *Id.*
221 Hannan & Thomas, *supra* note 11, at 233.
222 Comment, *supra* note 209, at 822–23.
223 Hannan & Thomas, *supra* note 11, at 248–49.
224 421 U.S. 837 (1975).

clearly rejecting the theory the Court dodged the issue in the following way:

> "Respondents urge us to abandon the element of profits in the definition of securities and to adopt the 'risk capital' approach articulated by the California Supreme Court....Even if we were inclined to adopt such a 'risk capital' approach we would not apply it in the present case. Purchasers of apartments in Co-op City take no risk in any significant sense."[225]

Although the federal courts have been reluctant to adopt the *Silver Hills* reasoning,[226] the decision has proved to be a catalyst for commentators who have offered analyses and tests to be used in defining a security.[227] Professor Coffey has analyzed the economic realities of a security by ascertaining the characteristics or features of a transaction which necessitate its being subject to the specialized anti-fraud protection afforded by the securities laws. His resulting definition of a security is as follows:

> "A 'security' is:
> "(1) A transaction in which
> "(2) a person ('buyer') furnishes value ('initial value') to another ('seller'); and
> "(3) a portion of initial value is subjected to the risks of an enterprise, it being sufficient if –
> "(a) part of initial value is furnished for a proprietary interest in, or debt-holder claim against, the enterprise, or
> "(b) any property received by the buyer is committed to use by the enterprise, even though the buyer retains specific ownership of such property, or
> "(c) part of initial value is furnished for property whose present value is determined by taking into account the anticipated but unrealized success of the enterprise, even though the buyer has no legal relationship with the enterprise; and
> "(4) at the time of the transaction, the buyer is not familiar with the operations of the enterprise or does not receive the right to participate in the management of the enterprise; and

225 421 U.S. at 857 n. 24 (citations omitted).

226 As to be expected, the reasoning of Silver Hills has been adopted in other California decisions; *see* Hamilton Jewelers v. Dept. of Corps., 112 Cal. Rptr. 387 (3d Dist. Ct. App. 1974); People v. Walberg, 69 Cal. Rptr. 457 (2d Dist. Ct. App. 1968).

227 *See e.g.* Coffey, *The Economic Realities of a Security: Is There a More Meaningful Formula?*, 18 WESTERN RES. L. REV. 367 (1967); Hannan & Thomas, *supra* note 11; Long, *supra* note 5.

> "(5) the furnishing of initial value is induced by the seller's promises or representations which give rise to a reasonable understanding that a valuable benefit of some kind, over and above initial value, will accrue to the buyer as a result of the operation of the enterprise."[228]

Coffey's definition is designed to meet what he regards as major deficiencies in the *Howey* test: the attenuation or the ignoring of the risk of loss of the original value furnished by the purchaser, the ambiguity of "common enterprise" in the *Howey* test, and its undue emphasis on the inducement of future "profits" (which is itself ambiguous) coupled with a de-emphasis of the risk of immediate loss of initial investment.[229]

The first three paragraphs of the Coffey test basically follow the *Silver Hills* risk capital approach, with amendments to reflect arrangements that have been invented by various promoters recently. Under the fourth paragraph, however, Coffey adds a new dimension by stipulating that the buyer not be familiar with the operations of the enterprise or not receive the right to participate in the management of the enterprise, since if he does either of these things he should not be entitled to the protection afforded by registering the security or by having the anti-fraud remedies under the securities act. In other words, investor participation or sophistication would take the instrument out of the ambit of the securities act by reducing the possibility of fraud in the transaction.

Other commentators have formulated similar tests emphasizing the risk capital aspect of the transactions. For example, Professor Long has offered the following definition:

> "A security is an investment of money or money's worth including goods furnished and/or services performed in the risk capital of a venture with the expectation of some benefit to the investor where the investor has no direct control over the investment or policy decisions of the venture."[230]

Coffey's analysis was adopted by the Supreme Court of Hawaii in *State Commissioner of Securities v. Hawaii Market Center, Inc.*[231] This case involved a securities prosecution against a founder-member contract arrangement which involved recruiting investors by selling cards to be used at a store that was to be built. In

228 Coffey, *supra* note 227, at 377.

229 *Id.* at 374–75.

230 Long, *supra* note 5, at 128. The definition has been adopted by the Oklahoma legislature as one of the alternative definitions of security; *id.* at n. 150.

231 485 P.2d 105 (Hawaii 1971).

holding an investment contract was present, the court felt that the *Howey* test was too mechanical and that

> "courts become entrapped in polemics over the meaning of the word 'solely' and fail to consider the more fundamental question whether the statutory policy of affording broad protection to investors should be applied even to those situations where an investor is not inactive, but participates to a limited degree in the operation of the business."[232]

The Supreme Court of Hawaii went on to hold that, for purposes of the Hawaii Uniform Securities Act, an investment contract is created whenever: (a) an offeree furnishes initial value to an offeror, and (b) a portion of this initial value is subjected to the risks of the enterprise, and (c) the furnishing of the initial value is induced by the offer or a promise or representations which give rise to a reasonable understanding that a valuable benefit of some kind, over and above the initial value, will accrue to the offeree as a result of the operation of the enterprise, and (d) the offeree does not receive the right to exercise practical and actual control over the managerial decisions of the enterprise.[233]

D. SPECIAL TRANSACTIONS OR ARRANGEMENTS AS SECURITIES

There seems to be no end to the cases that have arisen in the United States on the question of whether or not certain transactions or arrangements involve securities. What follows is a brief review of some of the major areas of dispute which have been grouped under headings by subject matter for purposes of convenience only.

At the outset, it is interesting to note that all of the cases dealing with special transactions or arrangements involve a common element, namely, the sale or exchange of property or services or a combination of property and services. The question becomes one of deciding whether that is *all* that is involved, since if that is the case, then a commercial transaction has taken place without any implications for the securities statutes. On the other hand, if something more than the sale of goods or services is present, the courts and administrators have held that a security is also involved. The difficulty has been to define or identify the factors which indicate that a security has been traded. In this section of the paper, the investment contract phrase is also relevant since that phrase has been interpreted to embrace many of the special

232 *Id.* at 108.
233 *Id.* at 109.

transactions or arrangements held to be securities. However, there are also other branches of the definition of security which have been resorted to in order to hold that such transactions or arrangements are securities.[234]

Somewhat prophetically, the U.S. Supreme Court in the *Joiner*[235] decision cautioned that:

> "the reach of the Act does not stop with the obvious and commonplace. Novel, uncommon, irregular devices, whatever they appear to be, are also reached if it be proved as a matter of fact that they were widely offered or dealt in under terms or courses of dealing which established their character in commerce as 'investment contracts', or as 'any interest or instrument commonly known as a security'."[236]

Some of the "novel, uncommon, irregular devices" to be examined for purposes of illustration are multi-level distributorships, franchises, commodities, land-related transactions, and notes.[237]

234 The commentary on the subject is almost as extensive as the cases dealing with the various transactions or arrangements. In addition to the articles already cited - *e.g.* Hannan & Thomas, *supra* note 11; Long, *supra* note 5; Long, *supra note* 196; Coffey, *supra* note 227; and Comment, *supra* note 209, at 815 - some other recent and useful articles are: Newton, *What Is a Security? A Critical Analysis*, 48 Miss. L.J. 168 (1977); Mofsky, *Some Comments on the Expanding Definition of "Security"*, 27 U. Miami L. Rev. 395 (1973); Selvers, *Investment Contracts: Expanding Effective Securities Regulation*, 48 St. John's L. Rev. 525 (1974); Bonnett, *How Common Is a "Common Enterprise"?*, 16 Arizona St. L.J. 339 (1974); Tew & Freedman, *In Support of SEC v. W.J. Howey Co.: A Critical Analysis of the Parameters of the Economic Relationship between an Issuer of Securities and the Securities Purchaser*, 27 U. Mo. L. Rev. 407 (1973).

235 320 U.S. 344 (1943).

236 *Id.* at 351.

237 One of the many transactions or arrangements not discussed herein but of considerable importance is the recent controversy in the United States over whether non-contributory pension plans are subject to the securities laws. It is well accepted that employee interests in contributory private pension plans may be subject to the federal securities legislation; *see* Mundheim & Henderson, *The Applicability of the Federal Securities Laws to Pension and Profit-Sharing Plans*, 29 Law & Contemp. Probs. 795 (1964). In Daniel v. Int'l Bhd. of Teamsters, 516 F.2d 1223 (7th Cir. 1977), the Seventh Circuit held that the plaintiff-employee's interest in a non-contributory pension plan was an investment contract and hence a security thereby entitling the plaintiff to the protection provided by the anti-fraud provisions of the securities laws. The reasoning was that Daniel's investment was his labour and the excess of retirement benefits over contributions was the expectation of profit so that the requirements of the Howey test, namely, an arrangement whereby a person invests his money in a common enterprise with an expectation of profits from the efforts of others, was fulfilled. A "sale" of the security pursuant to s. 2(3) of the Securities Act of 1933 which defines sale as a "disposition for value" was involved because Daniel gave value (his labour) in exchange for the pension interest. The Seventh Circuit did not concede a sale had to be voluntary but said the employees' vote ratifying the union contract which included the pension plan and subsequent votes reflected the necessary voluntary investment decision as did the continuing

1. *Multi-Level Distributorships: Pyramid Sales and Plans and Founder Membership Programs*

There can be a variety of so-called multi-level distributorship schemes. Under one, the pyramid scheme, an arrangement exists for selling a product or service through a multi-level network of independent distributors. The purchase of a distributorship entitles the purchaser to recruit other investors and to earn a finder's fee for each new purchaser. It becomes much more profitable to recruit purchasers than to sell the product or service. The recruits are lured by promises of easy money which are made in high-pressure recruiting sessions that have been characterized as revival meetings.[238] Another type of multi-level distributorship scheme involves the founder's contract. Under this arrangement, a promoter recruits investors by selling cards to be used at a store that he will build. The purchaser of the cards also buys the right to sell other people the cards and to earn commission fees for every card sold. Very often no store is ever built. The effect is similar to that in chain letters: those who come in late realize the market is saturated.[239]

One of the most notorious individuals involved in these schemes was Glenn W. Turner who promoted two well-known multi-level distributorship plans: motivational courses through his company called "Dare To Be Great, Inc." and cosmetics through another company, Koscot Interplanetary Inc. In looking at ways to halt these promotions, many of the states found that the schemes involved a security, while others rejected the claim that the arrangements involved securities.[240] A major stumbling block to

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employment. The U.S. Supreme Court granted *certiorari* on February 21, 1978; *see* Nimkin, *The Daniel Case*, 11 Rev. Sec. Reg. 963 (February 28, 1978).

Because of the amount of money and persons affected, a decision of the Supreme Court is anxiously awaited. *See also* Gunderson, *Application of the Federal Securities Laws to Non-Contributory, Defined Benefit Pension Plans*, 45 U. Chi. L. Rev. 124 (1977); Brown, *Securities Regulation of Employee Pension Plans: In the Wake of the Daniel Decision*, 38 U. Pitt. L. Rev. 697 (1977).

238 Comment, *supra* note 209, at 826.

239 *Id.* at 827. In one scheme, the SEC calculated that, if each person were to get five new investors a month as requested, there would be 305,175,780 people selling at the end of one year; *id.* at n. 41.

240 For decisions holding that a security was involved, *see e.g.* Hurst v. Dare To Be Great, Inc., 474 F.2d 483 (9th Cir. 1973); Frye v. Taylor, 263 So. 2d 835 (Fla. Dist. Ct. App. 1972). For decisions holding that no security was involved, *see e.g.* Gallion v. Alabama Market Centers, Inc., 213 So. 2d 841 (Ala. 1968); Georgia Market Centers, Inc. v. Forston, 171 S.E.2d 620 (Ga. 1969). *See generally* Note, *Pyramid Scheme Regulation: The Evaluation of Investment Contracts As a Security under the Federal Securities Law*, 25 Syracuse L. Rev. 690 (1974).

holding that a security was involved centred on the fourth element of the *Howey* test, namely, that the profit had to arise "solely" from the efforts of another. The first three elements of *Howey*, investments in a common enterprise with the expectation of profits, presented no problem. But since the investor was required to solicit more purchasers himself, he obviously was involved and participated such that his participation and effort were part of making a profit, and hence he arguably did not "solely" rely on others.

However, in *SEC v. Glenn W. Turner Enterprises, Inc.*[241] the Ninth Circuit held that the pyramid scheme did fit into the definition of a security as defined by the *Howey* decision. The court interpreted "solely" in the *Howey* decision as meaning: "...whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise"[242] and explained its decision as follows:

> "We hold, however, that in light of the remedial nature of the legislation, the statutory policy of affording broad protection to the public, and the Supreme Court's admonitions that the definition of securities should be a flexible one, the word 'solely' should not be read as a strict or literal limitation on the definition of an investment contract, but rather must be construed realistically, so as to include within the definition those schemes which involve in substance, if not form, securities."[243]

In addition to finding that the investor's efforts in *Turner* were not "essential" enough to negate the existence of a security, and to pointing to potential loopholes by interpreting "solely" too literally or strictly, the court characterized these efforts as part of the initial investment required to capitalize the operation at the outset.[244]

Turner has received considerable comment and criticism. One critic says that the court interpreted the efforts made by the purchasers not to be significant compared to the efforts of the Turner professional men on whom the purchasers relied to make the scheme successful because it was the Turner salesmen who ran the meetings and persuaded the recruits that they would make

241 348 F. Supp. 766 (D. Ore. 1972), *aff'd*, 474 F.2d 476 (9th Cir. 1973), *cert. denied*, 414 U.S. 821 (1973).

242 474 F.2d at 482.

243 *Id.*

244 Because of its holding that an investment contract was present, the 9th Circuit did not deal with the alternative findings of the district court in 348 F. Supp. at 772

such easy money.[245] The conclusion of the court was that those who bought into the ventures were really buying the right to share in the selling efforts of the professional salesmen without whose efforts the scheme would have failed. To get their return, the purchasers invested their money, efforts to find prospects and bring them to meetings, and whatever costs they incurred to create an appearance of affluence sufficient enough to lure others to join the venture. Pointing this out, the critic goes on to say that the court's reasoning was flawed, because from a factual standpoint, the court assumed the non-managerial efforts were insignificant to the success of the venture.[246] However, he points out that in such a scheme the role of the purchaser-salesman appears essential, since without his solicitation, sales and profits would not materialize. Furthermore the court played down the purchaser's active role implying that the purchasers contributed only a modicum of effort when in fact the record disclosed otherwise by the fact that they put in long hours seeking out prospects and attending meetings. This critic also says that the legal reasoning of the court is equally assailable because prior cases established that "any effort, physical or otherwise, exerted by the investor, regardless whether this effort had any bearing on the control of the enterprise", would disqualify a scheme as a security.[247]

Another critic of the decision states that the test of *Turner* misses the point. The efforts provided by the investor should not refer to physical activities of the investor but his right to share in the management or decision-making process of the project and, under those terms, the "solely" test from *Howey* is the appropriate one.[248] This critic also says that the test should be not solely through the efforts of others, but rather does the investor have any direct control over the investment or policy decisions of the venture.[249] To illustrate his point, he gives the example of the two-person law partnership where each under the *Turner* test would render significant efforts and therefore a partnership interest would not be a security;[250] but in the case of a 400-person

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that the pyramid scheme was "commonly known as security" or that the scheme involved a "certificate of interest in a profit-sharing agreement".

245 Press, *Securities Regulation: Investment Contract Redefined*, 27 U. MIAMI L. REV. 487, 492 (1973). For other case comments, *see* 6 CREIGHTON L. REV. 450 (1973); 52 N.C.L. REV. 476 (1973); 51 TEX. L. REV. 788 (1973).

246 Press, *supra* note 245, at 492.

247 *Id.* The quoted language is from Long, *supra* note 196, at 145.

248 Long, *supra* note 5, at 122.

249 *Id.*

250 On partnership interests as securities, *see* Erwin, *Partnership Interests As Securities: An Alice in Wonderland Tour*, 9 CREIGHTON L. REV. 310 (1975); Higgins, *Is a Limited Partnership Interest a "Security"? The Current State of the California and*

partnership the *Turner* court would hold that an individual member's management voice would be so small as to be insignificant and therefore the partner's interest *would* be a security. Under the analysis suggested above, however, in the case of each partnership there would be a sharing in the control over the investment and policy decisions of the venture, so that neither partnership would create a security interest.[251]

In *SEC v. Koscot Interplanetary Inc.*[252] a multi-level distributorship scheme involving cosmetics run by the Turner empire was also held to be a security based on the analysis of the Ninth Circuit in the *Turner* case. Again the court found the first three elements of *Howey* were met but had more difficulty finding the "solely" requirement fulfilled. The court mentioned it would apply a functional analysis to avoid frustrating the remedial purposes of the Securities Act of 1933 and noted that the trend among circuit courts was to liberalize the strict adherence to the *Howey* test.[253]

2. *Franchises*

Franchising has become an extremely popular form of business organization both in the United States and Canada.[254] Under the so-called product and service franchise system, the franchisor will license the distribution of its manufactured products under its name and trademark, such as with gasoline and automobile dealers. A second type of franchise involves the "trademark licence" by which the franchisee purchases the right to sell goods and services which he obtains under the franchisor's name, as in the fast food business. One of the major questions on characterizing franchise arrangements as securities is whether or not the franchisee is relying "solely on the efforts of others" as required by the *Howey* test.[255]

Federal Definitions Add a Legal Dimension to Economic Speculation, 16 SANTA CLARA L. REV. 311 (1976); *see also* Hirsch v. duPont, 396 F. Supp. 1214 (S.D.N.Y. 1975).

251 Long, *supra* note 5, at 122.

252 497 F.2d 473 (5th Cir. 1974).

253 Other federal courts have followed the 9th Circuit in *Turner*: *e.g.* Lino v. City Investing Co., 487 F.2d 689 (3d Cir. 1973); Mitzner v. Cardet Int'l, Inc., 358 F. Supp. 1262 (N.D. Ill. 1973). For a reference to legislative attempts by the U.S. Congress to deal with pyramid schemes, *see* Note, *supra* note 209, at 833-34.

254 For descriptive works on franchising, *see* E. LEWIS & R. HANCOCK, THE FRANCHISE SYSTEM OF DISTRIBUTION (1963); J. CURRY, PARTNERS FOR PROFIT (1966); in Ontario, *see* GRANGE REPORT, *supra* note 185.

255 For commentary on the question of whether franchises are securities, *see* Goodwin, *Franchising in the Economy: The Franchise Agreement As a Security under Securities Acts, Including 10b-5 Considerations*, 24 BUS. LAW. 1311 (1969); Comment, *The Franchise Agreement: A Security for Purposes of Regulation*, [1970] U. ILL. L.F. 130;

In an opinion of the California Attorney-General, he concluded that in certain situations, where the franchisee participates fairly actively but also furnishes some of the risk value to the franchisor, two separate business ventures are being carried on: one, the franchise business, and the other, the enterprise conducted by the franchisor which in fact is financed by the franchisee's risk capital.[256] This was the so-called "dual investment" theory which provoked considerable favourable and unfavourable criticism.

In *Mr. Steak, Inc. v. River City Steak, Inc.*,[257] the Federal District Court for Colorado held that a restaurant franchise arrangement was not a security within the meaning of section 2(1) of the Securities Act of 1933. In that case the franchise agreement provided that the franchisor, which was a national restaurant chain, had the right to control the franchisee-restaurant's operations including the selection of the manager. On the other hand, the franchisee had the right to terminate the manager's employment and had the right to participate in the conduct of the restaurant's business. The court concluded that the exercise of control over the franchise operation was not conclusive, since the franchisee exercised some control and had delegated or abandoned other powers under the agreement. In effect, because the investor in *Mr. Steak* was informed of the nature of the investment and had the right, even though unexercised, to affect the investment's success, the arrangement did not satisfy the "solely" requirement of the *Howey* test. Several other courts since the decision of *Mr. Steak* have held that franchises are not securities within the meaning of the federal legislation.[258]

There is no question that considerable potential for abuse is present in the franchise field. This abuse arises from the disparate economic power between the franchisor and the franchisee as well as the possibility that the franchisor might not account fully to the franchisee. It has been pointed out that these abuses can be controlled by an effective disclosure system provided by the securities laws or a similar system.[259]

Note, *Franchisor Liability under Securities Laws*, 13 WASHBURN L.J. 68 (1974); Comment, *Franchise Sales: Are They Sales of Securities?*, 34 ALB. L. REV. 383 (1970).

256 49 Cal. Op. Att'y Gen. 124 (1967) *cited in* Comment, *supra* note 209, at 836. The opinion characterized the situation where the franchisee participates only nominally in the enterprise as a security and not a security where he participates actively and the franchisor provides goods and services.

257 324 F. Supp. 640 (D. Colo. 1970).

258 *See e.g.* Hill York Corp. v. American International Franchises, Inc., 448 F.2d 680 (5th Cir. 1971); Mitzner v. Cardet International, Inc., 358 F. Supp. 1262 (N.D. Ill. 1973).

259 Comment, *supra* note 209, at 838-39. It has been effectively argued that the franchisee is like the investor in the multi-level distributorship in that both rely

In *Wieboldt v. Metz*[260] the franchise agreement contemplated active participation by the franchisee who actually controlled and operated the franchise. The question was whether the franchisee's active participation was outweighed by his being dependent on the franchisor. The court held that it was not and found that there was no investment contract. The court stated that it was necessary only that the franchisee exercise policy-making power over his particular unit of the franchise enterprise, since to require control over the franchisor's entire system would be incompatible with the franchising method and indeed would make all franchises investment contracts.[261]

3. *Commodities*

Commodity-based transactions have given rise to many cases under the U.S. securities laws. To a layman, the sale of gold or silver coins, whisky, hogs, or cocoa would not be thought of as sales of securities; however, owing to the ingenuity of promoters, the cases in this area have not been so simple. Again, there is a lengthy commentary on the treatment of commodities under the securities laws,[262] but only a few aspects will be dealt with in this paper – commodity-based transactions (whisky warehouse receipts), commodity futures contracts, naked commodity options and discretionary commodities trading accounts – followed by some brief comments on recent legislative regulation of the commodities field.

a. *Commodity-Based Arrangements: Whisky Warehouse Receipts*

The SEC has been fairly vigilant about the sale of whisky warehouse receipts. It has warned that promotion and sales literature on such receipts are subject to the anti-fraud provisions of the

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almost entirely on the promotional efforts of the franchisor and neither anticipates a decision-making role with respect to their investment. "Their profit-making activity consists mainly of physical labor and following the rules"; Hannan & Thomas, *supra* note 11, at 260.

260 355 F. Supp. 255 (S.D.N.Y. 1973).

261 *Id.* at 260. The court found that the franchise was also not a security under the risk-capital analysis of Silver Hills Country Club v. Sobieski, *supra* note 216.

262 *See generally* Note, *Federal Regulation of Commodities Futures Trading*, 60 YALE L.J. 822 (1951); Borton & Abrahams, *Options on Commodity Futures Contracts As Securities in California*, 29 BUS. LAW. 867 (1974); Bromberg, *Commodities Law and Securities Law – Overlap and Pre-emptions*, 1 J. CORP. L. 217 (1976); Roberts, *Abuses in the Commodity Markets: Some Suggestions for Control*, 25 SYRACUSE L. REV. 788 (1974).

federal securities laws because the receipts have been interpreted as securities.[263]

In the first of some recent decisions involving whisky warehouse receipts, *SEC v. M.A. Lundy Associates*,[264] the district court held that whisky warehouse receipts are securities within the meaning of section 2(1) of the Securities Act of 1933. The defendants had placed newspaper advertisements inviting "investments in profit and growth in scotch whisky". Relying on the *Joiner* and *Howey* decisions of the U.S. Supreme Court, the district court found that the whisky warehouse receipts were investment contracts. In rejecting the defendants' argument that the sales involved commodities only, the court stated that the investor's purpose was to realize a profit on resale, and to do that he depended on the broker's advice. In this and similar cases,[265] the courts have pointed to the investment representations made by the defendants and the reliance by the investors on the expertise of the defendants in managing the investments.

b. *Commodity Futures Contracts*

A commodity futures contract is basically an agreement to buy a fixed amount of a commodity at a future date. In most cases, there is no intention to take delivery of the commodity, and obligations to buy are frequently offset by agreements to sell at the time of delivery. Buying and selling commodity futures can provide valuable benefits[266] and have attracted a number of investment speculators. There is now considerable trading on the various commodity exchanges.

In *Sinva, Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,[267] the district court applied the *Howey* test to hold that a typical commodity futures contract was not a security. The court stated that there was no "common enterprise to realize a profit"

263 *See* SEC, Securities Act of 1933 Release No. 5451, Securities Exchange Act of 1934 Release No. 16586, January 7, 1974, [1973-74 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 79,618; *see also* SEC Securities Act of 1933 Release No. 5018, November 4, 1969, [1969-70 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,757. As pointed out by the SEC, many false and misleading statements are made with respect to sale of receipts which are of fundamental importance, *e.g.*, the promised returns often turn out to be losses, facts about the types and prices of whisky are not given and facts about difficulties in reselling the receipts are also omitted.

264 362 F. Supp. 226 (D.R.I. 1973). But there was an earlier flurry of whisky cases: *see* Penfield Co. v. SEC, 143 F.2d 746 (9th Cir. 1944); SEC v. Bourbon Sales Corp., 47 F. Supp. 70 (W.D. Ky. 1942).

265 A similar conclusion to Lundy was reached in SEC v. Haffenden-Rimar, International Inc., 362 F. Supp. 323 (E.D. Va. 1973).

266 One of the principal benefits in the purchase of commodity futures contracts is the hedge against unfavourable price changes.

267 253 F. Supp. 359 (S.D.N.Y. 1966).

(within the *Howey* test) between the plaintiff and its broker, the defendants. There was in fact simply a broker-client relationship with the plaintiff having the right to decide whether to accept the commodity or offset the future contract by another trade.[268] Other cases have also made it clear that ordinary commodity futures contracts are not securities.[269] In short, the cases have concluded that the "common enterprise" and "reliance on efforts of others" elements of *Howey* are not applicable in the sale or purchase of a commodity futures contract.

c. *Naked Commodity Options*

Under the "naked" commodity option schemes, the investor purchases an option to buy or sell (or both buy and sell) a futures contract from or to the promoter at a fixed price within a specific period. The options are "naked" because the promoter has not bought the futures contract to which the option relates. The promoter uses the funds to raise additional capital. The investor gains when he correctly guesses the position of the market at the future time and exercises his option with the promoter; the investor loses if he misjudges the market or if the promoter is unable to raise the funds to pay the investor's claim upon exercise of the option – an event which happens quite frequently and has given securities administrators considerable concern.

One of the major decisions on naked options is *People v. Puts & Calls, Inc.*[270] The court rejected the argument made by the defendant that the option took on the character of the underlying instrument, a commodity futures contract which by *Sinva*[271] was held not to be a security. The court held that coupled with the sale of options was the sale of an investment contract. In this respect the defendant argued that the "common enterprise" element of *Howey* was not present since the gain or loss of the investor was attributable to his reading the market properly. In addition, the defendant argued that profit was not "solely" dependent on the efforts of others. The court in answer stated the profit was dependent on the promoter's ability to raise additional capital through investing the commingled accounts of the investors' pay-

268 *Id.* at 366. The court also said that the SEC should not be accorded jurisdiction to regulate commodities in light of the congressional intent to regulate through another agency, The Commodity Exchange Authority, under the Commodities Exchange Act, 7 U.S.C. ss. 1-17a (1970); 253 F. Supp. at 367; *cf.* text accompanying note 284 ff. *infra*.

269 *E.g.* Glen-Arden Commodities, Inc. v. Constantino, 493 F.2d 1027 (2d Cir. 1974); Berman v. Dean Witter & Co., 353 F. Supp. 669 (C.D. Cal. 1973); Schwartz v. Bache & Co., 340 F. Supp. 995 (S.D. Iowa 1972).

270 3 CCH Blue Sky L. Rep. ¶ 71,090 (Cal. 1973).

271 253 F. Supp. 359 (S.D.N.Y. 1966).

ments.[272] Other similar schemes, notably those promoted by one individual, Harold Goldstein, who attracted millions of dollars from investors through his company, Goldstein Samuelson, Inc., were also held to be securities.[273]

d. *Discretionary Commodity Trading Accounts*

Between the commodity futures contract and the naked commodity option for purposes of finding a security is the discretionary commodities account.[274] These arrangements involve investors advancing funds to a broker in a joint account in the expectation of profits on the efforts of the broker. Under the *Howey* test, the only element in question is whether there is a "common" enterprise associated with discretionary commodities accounts.

In one of the first cases dealing with such accounts, *Maheu v. Reynolds & Co.*,[275] the court concluded that an investment contract was present and rejected the argument that the common enterprise requirement was not met.[276] However, the reasoning leading to this result was somewhat cryptic. Other cases followed *Maheu*[277] and the issue seemed clearly decided until the 7th Circuit decision in *Milnarik v. M.S. Commodities, Inc.*[278] which held that a discretionary commodities account was not a security.[279]

In that case, the only compensation received by the defendant was from commissions on the trades and not on the profitability of the transactions made by the defendant. Also, there was no commingling of funds with any other discretionary commodity accounts. The court found no common enterprise element, pointing

272 It is interesting that the California court did not apply the risk-capital analysis of Silver Hills which seemed to be appropriate because the investors provided capital in a speculative high-risk enterprise; *see* Bloomenthal, *Calls, Puts and Commodity Options*, 2 SEC. REG. L.J. 101 (1974).

273 After only a two-year period the Samuelson corporation declared bankruptcy with some $17 million in assets and $76 million in liabilities; *see* Hannan & Thomas, *supra* note 11, at 270; *see generally id.* at 269–74 for an analysis of the Samuelson litigation.

274 Comment, *supra* note 209, at 844.

275 282 F. Supp. 428 (S.D.N.Y. 1967).

276 The common enterprise requirement was given close analysis in Los Angeles Trust Deed & Mortgage Exchange v. SEC, 285 F.2d 162 (9th Cir. 1960). The case involved purchasers advancing money for notes secured by deed of trust on property managed by the seller. The money was pooled and reinvested by the promoters. The court stated the common enterprise element of Howey was met by either a pooling of interests or a commonality of interest between the purchaser and seller.

277 Berman v. Orimex Trading, Inc., 291 F. Supp. 701 (S.D.N.Y. 1968); Johnson v. Arthur Espey, Shearson Hammill & Co., 341 F. Supp. 764 (S.D.N.Y. 1972).

278 320 F. Supp. 1149 (N.D. Ill. 1970), *aff'd*, 457 F.2d 274 (7th Cir. 1972), *cert. denied*, 409 U.S. 887 (1972).

279 Another argument made was that, even if a security were involved, a private offering exemption was available pursuant to s. 4(2) of the Securities Act of 1933. The court held the exemption was applicable; *but see* Comment, *supra* note 209 at 846 n. 171.

out: (1) that assuming money was collected from numerous parties, no allegation was made that there was a common enterprise comprising all those who had discretionary accounts with the defendant, (2) no claim was made that the defendant traded in a uniform manner for each account, or even if there had been uniform trading, no pooling of funds for common purpose was alleged, and (3) plaintiffs in no way could be viewed as having invested in a common enterprise with other suppliers of venture capital. The court said that an agency relationship was involved, not a security, and relying on the lower court found that each contract between the customer and broker was unitary and independent of the others. The decision has been followed by others.[280]

Thus there are two lines of cases on the question of whether discretionary commodities accounts are securities. From an analytical viewpoint the *Milnarik* analysis holding no security is more acceptable;[281] on the other hand, if one looks to the general policy of protection under the Securities Act of 1933, the *Maheu* conclusion of treating such accounts as securities is more attractive.[282]

e. *Legislative Intervention*

It should be mentioned that there is a federal agency in the United States which has been given regulatory authority over the commodities field. The Commodity Exchange Act of 1922 was passed by Congress to regulate brokers trading on commodity exchanges. Certain provisions of the act regulated such matters as excessive speculation, financial integrity of brokers, and the handling of customers' accounts. The act also contained an anti-fraud provision and created the Commodity Exchange Authority which was responsible for the regulatory features of the statute. However, two major limitations of the act and the authority were that the former concerned a restricted number of commodities (largely agricultural products only) and the latter did not have the resources to perform effectively.[283] Added to these difficulties was the fact that the volume of commodity futures trading increased dramatically to the extent that in 1972–73 the total of $400 billion

280 Wasnowic v. Chicago Board of Trade, 352 F. Supp. 1066 (M.D. Pa. 1972), *aff'd*, 491 F.2d 752 (3d Cir. 1973); Stuckey v. DuPont Glore Forgan, Inc., 59 F.R.D. 129 (N.D. Cal. 1973); *but cf.* SEC v. Continental Commodities Corp., 497 F.2d 516 (5th Cir. 1974).

281 This is the conclusion reached by Hodes & Dreyfos, *Discretionary Trading Accounts in Commodity Futures - Are They Securities?*, 30 Bus. Law. 99 (1974).

282 *See* Comment, *supra* note 209, at 846–49.

283 *Id.* at 848, *citing* Wolff, *Comparative Federal Regulation of the Commodities Exchanges and the National Securities Exchanges*, 38 Geo. Wash. L. Rev. 223, 263–64 (1969).

exceeded the total value of securities trading.[283a] Concerns were expressed about the ability of the commodity exchanges to regulate themselves and market practices generally.

To achieve a more comprehensive and effective regulatory system, the U.S. Congress enacted the Commodity Futures Trading Commission Act of 1974[284] which transferred existing powers in various officials and agencies to a newly created Commodity Futures Trading Commission. The operation of the act has been summarized as follows: (1) the subject matter regulated has been substantially expanded to cover a very wide range of commodities, (2) fraud protection and the power of the commission to control excessive speculation have been broadened, (3) registration and regulation are provided for floor brokers, futures commission merchants, commodity trading advisers, and commodity pool operators, and (4) the commission is empowered to regulate boards of trade and designate them as contract markets.[285] The approach of the act appears to emphasize regulating the market actors in the commodities field, which is arguably preferable to expanding the meaning of investment contract under the definition of security for purposes of the securities laws.[286]

4. *Land-Related Transactions: Land Sales Contracts, Condominiums and Cooperatives*

Under this heading can be grouped a large number of disputes centring on the question of whether a transaction or arrangement involving realty could be termed a security. Just as the previous headings dealing with distributorships, franchises and commodities evoked an analysis of whether the sale of services or personalty was involved as opposed to a security, here the issue is whether real property or a security is involved. Again there are many real estate interests which are not discussed since only a few examples

283a *See* Commodities Report, *supra* note 164, at 47, *citing* Report on Commodity Futures Trading Commission Act of 1974, H.R. Rep. No. 13113, 93d Cong., 2d Sess. 39 (1974).

284 Pub. L. No. 93-463 (1974). California had passed its Commodity Law in 1973 as part of the California Corporations Code; Cal. Corp. Code, ss. 29500-92 (West 1977). The Commodity Law in regulating various commodity market actors provided for some coordination between the California law and the old federal statute; now the law applies only to matters not within the exclusive jurisdiction of the Commodity Futures Trading Commission; *see* Johnson, *The Perimeters of Regulatory Jurisdiction under the Commodity Futures Trading Commission Act*, 25 Drake L. Rev. 61, 67-70 (1975).

285 Comment, *supra* note 209, at 849. For a brief but helpful discussion of the U.S. Commodity Exchange Act and the CFTC and the California Commodity Law of 1973, *see* the Commodities Report, *supra* note 164, at 47-68.

286 This was advocated by Hodes & Dreyfos, *supra* note 281, at 110.

have been chosen. These are land sales contracts, condominium units and cooperative housing arrangements.[287]

At the outset it should be recalled that two of the U.S. Supreme Court decisions interpreting security, *Joiner* and *Howey*, involved land transactions. As so cogently put by L. Loss:

> "[N]o 'investment contract' is involved when a person invests in real estate, with the hope perhaps of earning a profit as a result of a general increase in values concurrent with the development of the neighbourhood, as long as he does not do so as part of an enterprise whereby it is expressly or impliedly understood that the property will be developed or operated by others."[288]

As with distributorships, franchises and commodities, it is not *what* is being sold that counts, but *how* it is being sold and on what basis.[289]

There is a great variety of land sales contracts which involve the sale of land coupled with the seller-promoter's representation to resell the land at a profit for the purchaser-investor.[290] In *Johnson v. Suburban Land Investment Co., Inc.*,[291] the promoter sold land in Virginia on instalment notes to investors under an agreement which allowed the promoter to build a residential subdivision. In following the *Howey* analysis, the court looked to the economic reality of the arrangement to override the provision of the agreement giving control of the land improvement to the investors. The reality was that only the developer had the necessary expertise to carry out the planning and construction of the new subdivision. The court concluded that the promoters obtained their required financing from the investors who bore the risk.[292]

287 Oil and gas interests as securities are a notable omission from the land-related interests discussed. *See* Meer, *The Securities Laws and Oil and Gas Financing*, 20 Tex. B.J. 211 (1957); *Student Symposium - Oil Interests As Securities: The Enumerated vs. The General Definition*, 6 St. Mary's L.J. 151 (1974). The sale of a fractional undivided interest in mineral rights, royalties or a mineral lease involves a security since such interests are contemplated by the definition of security under the Securities Act of 1933; Whittaker v. Wall, 226 F.2d 868 (8th Cir. 1955). Of course, oil and gas leases can also give rise to security interests; *see* SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1943), discussed in text accompanying note 191 *supra*.

288 1 L. Loss at 491-92.

289 Hannan & Thomas, *supra* note 11, at 274.

290 For a good description of typical arrangements, *see id.* at 275-77.

291 [1973-74 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,022 (Super. Ct. D.C. 1973).

292 *See also* SEC v. Lake Havaser Estates, 340 F. Supp. 1318 (D. Minn. 1972). On related matters, *see* Note, *Regulation of Real Estate Syndications: An Overview*, 49 Wash. L. Rev. 137 (1973); Note, *Securities: Another Way to Regulate the Resort Development Boom*, 27 Okla. L. Rev. 104 (1974); Burton, *Real Estate Syndications in Texas: An Examination of Securities Problems*, 51 Tex. L. Rev. 239 (1973); and Perelson, *State Securities Law: A Valuable Tool for Regulating Investment Land Sales*, 7 New Mex. L. Rev. 266 (1977).

The sales of condominium and cooperative housing schemes present more difficult problems. The purchaser of these interests does not normally expect any profit or monetary return since he is simply buying a residence, and thus the securities laws should not apply. On the other hand, if the purchaser is acquiring an investment in that he expects a profit, then the securities acts should apply just as they do with other investments.

With respect to condominium units,[293] there can be several features present that indicate a security is involved. One of these is the so-called "rent-pooling" arrangement whereby the owner rents his unit for a period in return for a percentage of the total rents pooled from all the condominium units involved.[294] A second investment feature is the sale of a condominium unit accompanied by a long-term management contract which is more akin to the classic *Howey* investment contract than the buying of a residence. The third feature of investments is the nature of advertising effort and effect: if the promoter's advertising effort emphasizes economic advantages to the purchaser from the management efforts of the promoter, the condominium could be characterized as a security. The SEC recently published a release condensing these features as guidelines to distinguish between condominiums and similar types of real estate developments on the one hand, and a security on the other.[295] As has been pointed out,[296] the SEC, instead of trying to differentiate between the "profits" expected by the purchaser of a security and of a residence within the *Howey* test and approach, has adopted a more pragmatic analysis by identifying the factors which make the condominium transaction look like one which presents abuses that could be rectified by the securities laws.

Under the cooperative housing schemes, a corporation or association is usually formed to buy an apartment building from the developer. The tenants buy "stock" or "shares" in the cooperative corporation or association entitling them to leases in the

293 On securities law aspects of condominiums, *see* Hoisington, *Condominiums and the Corporate Securities Law*, 14 HASTINGS L.J. 241 (1963); Clurman, *Condominiums As Securities: A Current Look*, 19 N.Y.L.F. 457 (1974); Dickey & Thorpe, *Federal Securities Regulation of Condominium Offers*, 19 N.Y.L.F. 473 (1974); Ellsworth, *Condominiums Are Securities?*, 2 REAL EST. L.J. 694 (1974); Berman & Stone, *Federal Securities Laws and the Sale of Condominiums, Homes and Homesites*, 30 BUS. LAW. 411 (1975).

294 *See* Rohan, *The Securities Law Implications of Condominium Marketing Programs Which Feature a Rental Agency or Rental Pool*, 2 CONN. L. REV. 1 (1969).

295 SEC, Securities Act of 1933 Release No. 5347, January 4, 1973, [1972-73 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,163; and *see Student Symposium - Real Estate Investments As Securities. The Sufficiency of the Howey Test*, 6 ST. MARY'S L.J. 166, 172 (1974).

296 Comment, *supra* note 209, at 851.

building and to vote in the election of directors who manage the corporation or association. Again the question becomes one of distinguishing between an investment giving rise to a security and the acquisition of a residence. This issue raises the elements of the *Howey* test and in particular whether the element of "expectation of profits" is present. Of paramount importance to this question is the recent U.S. Supreme Court decision in *United Housing Foundation, Inc. v. Forman*,[297] which held that stock in a cooperative housing nonprofit corporation was not a security; and reference should be made to the previous discussion of the case.[298]

5. *Notes*

As previously noted, the "investment contract" branch of the security definition has received more attention than any other. However, another branch of the definition which recently has been the focus of attention is the language "any note...or other evidence of indebtedness". If a literal reading of the statute were adopted, any note regardless of the circumstances under which it was issued would be subject to the securities laws unless a specific exemption could be found.[299] The cases have gone both ways, some holding that notes are securities and others that notes are not securities.[300]

Several important points have arisen from the various cases on notes. Initially, some courts were constrained to fall on the plain meaning of the statutory language which stated "any note" was a security.[301] This result was reinforced by applying the broad, remedial purpose of the securities statute to the question.[302]

297 421 U.S. 837 (1975).

298 *See* text accompanying notes 205-09 *supra*.

299 To accommodate commercial paper, the Securities Act of 1933 exempts from the registration but not fraud provisions notes used to finance current transactions and the Securities Exchange Act of 1934 excludes from the definition of security any note which has a maturity at time of issuance of not more than nine months; *see* Hicks, *Commercial Paper: An Exempted Security under Section 3(a)(3) of the Securities Act of 1933*, 24 U.C.L.A. L. Rev. 227 (1976).

300 The U.S. cases holding notes to be and not to be securities are listed in Lipton & Katz, *"Notes" Are Not Always Securities*, 30 Bus. Law. 763, 770-71 (1975). For an earlier article by the same authors; *see* Lipton & Katz, *"Notes" Are (Are Not?) Always Securities*, 29 Bus. Law. 861 (1975), *see also* Comment, *A Note Is a Note Is a Note*, 52 Neb. L. Rev. 478 (1973); Konstant, *The Status of the Promissory Note under the Federal Securities Laws*, 17 Ariz. St. L.J. 175 (1975); Note, *Notes As Securities under the Securities Act of 1933 and Securities Exchange Act of 1934*, 36 Md. L. Rev. 233 (1976).

301 *E.g.* Movielab, Inc. v. Berkey Photo, Inc., 321 F. Supp. 806 (S.D.N.Y. 1970), *aff'd*, 542 F.2d 662 (2d Cir. 1971).

302 *E.g.* MacAndrews & Forbes Co. v. American Barmag Corp., 339 F. Supp. 1401 (D.S.C. 1972).

However, other courts looked at the introductory language preceding the definition of security, namely, "unless the context otherwise requires", to hold that the securities acts were not intended to cover ordinary consumer or commercial transactions.[303] In addition, some courts have held that the issuance of notes did not involve the "purchase" or "sale" of a security.[304] The conclusion to be drawn from the recent cases[305] is that notes issued in what can be styled as commercial transactions are not securities, whereas those issued in investment transactions are securities. Although this is a flexible and adaptable test, there remains the difficulty of applying it to particular situations.

Chapter V
Interpretations of "Security" under Canadian Legislation

A. INTRODUCTION

In Canada, the number of cases on the definition of security is quite small when compared to the U.S. experience. However, a variety of arrangements and transactions have been presented in Canada which have similar features to those that have been the subject of judicial and administrative inquiry in the United States. This fact underscores the importance of cooperative administrative efforts among the various securities administrators in Canada and between those in Canada and their counterparts in the United States so that they can keep abreast of the new devices or schemes that are in reality securities. As with some of the U.S. jurisprudence, the Canadian decisions interpreting security have for purposes of discussion been grouped according to the subject matter of the arrangement or transaction. Because many of the Canadian decisions have not been commented on elsewhere, they have received more detailed attention in this paper.

303 *E.g.* Joseph v. Norman's Health Club, Inc., 336 F. Supp. 307 (E.D. Mo. 1971) (plaintiffs issued promissory notes to defendant for membership in health club). *See also* McClure v. First National Bank of Lubbock, Texas, 497 F.2d 490 (5th Cir. 1974).

304 Lino v. City Investing Co., 487 F.2d 689 (3d Cir. 1973) (personal promissory notes issued by plaintiff in part payment for a franchise sold by defendant). The court said that the notes did not involve the "purchase" or "sale" of a security since to accept plaintiff's argument would mean that any consumer who bought an article on time and issued a note would be able to sue in a federal court on the theory that the retailer had purchased his security.

305 These are discussed in Lipton & Katz, *supra* note 300, 30 Bus. Law. 763.

B. INTERPRETATIONS OF SECURITY

1. *Commodities and Other Types of Personalty*

a. *Swain v. Boughner*

In *Swain v. Boughner*,[306] the Ontario Securities Commission appealed the dismissal of a charge that the accused traded in securities without being registered as a broker or salesman under the Ontario Securities Act. The disputed transaction involved the sale of a half interest in a pair of chinchillas but the seller retained the chinchillas under a type of management contract and profit-sharing arrangement. The court held that it was a sale of or a trade in a security in conjunction with the sale of specific chinchillas or of an undivided interest in specific chinchillas. Accordingly, under the heading "any document constituting evidence of or title to or interest in the capital, assets or property...of any person or company", the arrangement was a security. However, as J. Williamson notes, the transaction might arguably have been held to be an "investment contract" within the meaning of that term especially as it has been subsequently determined.[307]

b. *Brigadoon Scotch Distributors*

Swain v. Boughner was recently applied in *Re OSC and Brigadoon Scotch Distributors (Canada) Ltd.*[308] In this case, warehouse receipts for Scotch whisky were traded through a broker, and the OSC brought an application for an order restraining the respondent company from trading in securities, which were alleged to be the Scotch whisky warehouse receipts, without being registered for trading as required under the Ontario Securities Act. Hartt, J., in granting the restraining order, referred to *Swain v. Boughner* and to the definition of security under clause (ii) of paragraph 22 defining security, which was the heading of the definition interpreted in the *Swain* case, and stated:

> "The definition would not include documents of title which are bought and sold for purposes other than investment, for example, bills of lading and receipts for goods purchased for inventory or consumption purposes. Such

306 [1948] O.W.N. 141 (H.C.). *See also* text accompanying note 51 *supra*.

307 J. WILLIAMSON, SUPP. at 103. The author cites Hollywood State Bank v. Wilde, 160 P.2d 846 (Cal. 2d Dist. Ct. App. 1945). For a recent decision concluding that a tax shelter scheme involving a cattle breeding arrangement was an investment contract and hence a security under the Alberta Securities Act, *see In re* Canadian Exotic Cattle Breeders Association, Alberta Securities Commission Summary, January 31, 1977, at 4 (denial of exemption).

308 [1970] 3 O.R. 714 (H.C.).

> an intention on the part of the legislature can be inferred from the basic aim or purpose of the *Securities Act, 1966*, which is the protection of the investing public through full, true, and plain disclosure of all material facts relating to securities being issued....The respondent is a minimum capitalization private company and does not own any of the whisky or the warehouse receipts forming the subject-matter of the dispute. However, the fact that the respondent company acts only as a broker or agent in the sales would not exempt it from the registration requirements of the *Securities Act, 1966*, as S. 6(1)(c) of the Act, quoted above, specifically includes acting as a salesman of or on behalf of a person or company in connection with a trade in a security."[309]

c. *John T. Geldermann*

In *Re John T. Geldermann & Company Inc.*,[310] the Quebec Securities Commission held that a commodity futures contract was not a security under the Quebec Securities Act. In coming to this conclusion, the commission examined two heads of the definition of security which are found in the various securities acts of the provinces. The first heading was any certificate, instrument or other document constituting the evidence of a right, share, or interest in the capital, assets, earnings or profits of any existing or proposed company, or of a person. On this branch of the definition, the commissioners concluded that the definition was not applicable because at the time of the trading, the company or person underlying the arrangement was not known and was impossible to determine.

The other branch of the definition of security dealt with by the commission was "generally any certificate, instrument or document commonly known in the trade as a security or designated as such by the regulations". With respect to this branch, the commission stated that, although commodities futures contracts are viewed by the securities industry as speculative opportunities, the commission was unable to conclude that such contracts are commonly known as securities *in the trade* at present.[311] It is interesting to note that in arriving at this conclusion, the commis-

309 *Id.* at 716-17. *See also* B.C. Securities Commission Weekly Summary, February 8, 1974, advising that investments in whisky warehouse receipts are securities requiring compliance with the prospectus provisions of the B.C. Securities Act. The Weekly Summary reproduced an article on the subject published by the SEC.

310 3 QSC Bull., No. 65 (July 11, 1972).

311 The Ontario Securities Act does not contain the phrase "in the trade" as a part of this branch of the definition.

sion relied on evidence submitted at the hearing and on information sought from persons engaged in the trade of securities and commodities. Counsel for Geldermann presented the views of the president of the Montreal and Canadian Stock Exchanges, a produce broker whose company was associated with a U.S. commodity futures broker, and a professional commodities speculator. The commission also examined the status of commodity futures brokers operating under various North American jurisdictions and cited the test of the Supreme Court of the U.S. in *SEC v. C.M. Joiner Leasing Corp.*:[312]

> "The test [of the definition of a security]...is what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect."

The commission also stated that proof of common knowledge must be based on an overwhelming set of facts and conclusive evidence. And on that basis they were unable to conclude that commodity futures contracts are commonly known as securities in the trade at present.[313]

d. *Farmex Enterprises*

Another animal-related transaction was involved in a recent decision of the Ontario Securities Commission, *In the Matter of Farmex Enterprises Incorporated.*[314] Farmex marketed "exotic beef breeding programs" whereby an investor could buy, for $2,500, a half-blood heifer or a cow inseminated pure-bred in the case of the non-availability of half-blood heifers. Purchase of the cow was accompanied by purchase of a participation in a breeding program designed to produce a pure-bred Chianina cow. The aim of the transaction was to get, through successive breeding, a pure-bred cow so that it would bring a high price on the market or that it could be used for further breeding, in which case the offspring would be sold to produce the profit.

The Ontario Securities Commission noted that the contract with Farmex involved much more than the purchase and sale of a heifer. Under the contract, Farmex undertook to maintain the animal and also to breed the animal to a full-blooded sire in the hope of producing a full-blooded cow, and also to provide adequate

312 320 U.S. 352 (1943); *see* text accompanying note 191 *supra.*

313 As noted above under the U.S. interpretations of security, an ordinary commodity futures contract has been held not to be a security under the investment contract heading; *see* text accompanying note 267 ff. *supra.* However, as previously stated in note 65 *supra*, the Quebec Securities Act does not contain the "investment contract" phrase in the headings of the definition of security.

314 [1974] OSC Bull. 50 (March). *See also* the decision of the Alberta Securities Commission regarding a cattle breeding arrangement, *supra* note 307.

veterinary supervision. Farmex automatically owned all the offspring of the purchaser's animal. Throughout the program, Farmex undertook to arrange for the sale of the purchaser's animal and also to maintain adequate insurance on the purchaser's animal against death and theft.

Counsel for Farmex argued that the agreement constituted the outright sale of an animal to investors. He also argued that there was no investment in a common enterprise in that the purchaser did not share in Farmex's profits. The purchaser owned his own animal throughout and was free at any time during the program to sell it. If the cow produced a female offspring he would naturally exchange the cow for that offspring so the program could continue. If a pure-blood were produced, the purchaser would profit by sale or further breeding. The purchaser's fortunes were dependent on the fate of his own property – the cow and the offspring for which it may be exchanged in the breeding program. Farmex's counsel also argued that the profits and losses were the purchaser's alone and related exclusively to his own property; and furthermore, the purchase of a cow was analogous to the purchase of an antique or a work of art which would appreciate over time.

Commission counsel relied on the principles laid down by the Supreme Court of the U.S. in *SEC v. W.J. Howey Company*.[315] It was noted that the Supreme Court, in giving the term investment contract a very broad meaning, emphasized that the intent of securities legislation was to afford the investing public a full measure of protection. Furthermore, when the question of security arises, emphasis should be placed on economic reality, and form is to be disregarded for substance so that the investing public receives full and fair disclosure relating to the issuance of "the many types of instruments in our commercial world that fall within the ordinary concepts of a security". Counsel also noted that this approach to securities legislation was adopted in recent Canadian decisions.[316]

The commission noted that it agreed with that approach in interpreting the Ontario Securities Act and stated:[317]

> "We are of the opinion that the economic reality in this case is clearly an investment by unsophisticated investors in a breeding program in the hope that through the efforts, the expertise, and the management of others, a profit will be realized. This is the essence of an investment

315 328 U.S. 293 (1946); *see* text accompanying note 194 *supra*.

316 Attorney-General of Alberta v. Great Way Merchandising Ltd., [1971] 3 W.W.R. 133 (Alta. S.C.); *In re* Bestline Products of Canada Ltd., [1972] 6 W.W.R. 245 (B.C.C.A.). These cases are discussed in text accompanying note 375 ff. *infra*.

317 [1974] OSC Bull. 50, 54 (March).

> contract which brings it within the definition of a security in the Act."

In rejecting the argument that what was involved was simply the sale and purchase of an animal, the commission viewed the nature of the entire arrangement as an investment contract. This conclusion was reinforced by one of the sections in the Farmex sales literature which asked the question: "Why shouldn't I simply buy the animal and not the program?" The answer supplied in the literature was: "You could, but you would need a lot of expertise and more money." On this point, the commission stated:[318]

> "This, surely, is the essence of the matter. A passive investor invests in a joint enterprise with additional funds being supplied by many other passive investors and depends upon the expertise, management and good faith of others to return a profit. In such cases, the full, true, and plain disclosure that is required by the Act is necessary for the protection of the investing public. That this is clearly so can be seen from the operation of the enterprise."

The commission then referred to the facts that Farmex did not own any of the farms and that it had to get continual financing of the program from further sales and from further sales of the investors' own cow when they were exchanged. Also, the evidence disclosed that the cost of a heifer was between $600 and $750, whereas the cost of investment in the program was some $2,500. The commission concluded that the money invested was used to pay for all the other services that Farmex provided. These facts were felt to illustrate the risks involved in the enterprise and the need for the type of disclosure that an investor would be entitled to have pursuant to the prospectus provisions of the Ontario Securities Act.

e. *Regina v. Ausmus*

In *Regina v. Ausmus*,[319] the appellant was charged with failing to comply with the Alberta Securities Act, and the issue was whether the appellant's activities constituted trading in a security. The appellant described himself as an "investment representative" of a company that was to manufacture a machine which would be installed in taverns and restaurants where a person for a fee could obtain a reading to determine the alcoholic content of his or her blood. The machines were to be sold to a purchaser for about $2,200 and leased back to the company for a $42.50 monthly

318 *Id.* at 55.
319 [1976] 5 W.W.R. 105 (Alta. Dist. Ct.).

rental for a term of five years, after which the machine would be resold to the company for $100 under arrangements which would provide a sharing of subsequent revenue from the machine. Under the agreements entered into, the company agreed to look after and maintain the machines, records and statements. Counsel for the Crown argued that the arrangement was a security and submitted that two headings of the definition were relevant: (1) "any profit-sharing agreement or certificate",[320] and (2) "any investment contract, other than an investment contract within the meaning of the Alberta Investment Contracts Act".[321] The argument of the appellant was that the arrangement was simply a sale of a chattel with a lease-back and repurchase agreement.

The court, after citing recent Canadian cases[322] which in turn adopted the test of an investment contract as enunciated by the U.S. Supreme Court in *Howey*, held that the arrangement was an investment contract. After referring to the main features of the arrangement, the court concluded:

> "In other words, it seems to me that the economic realities of the situation were that this was an investment contract and the actual ownership of the machine was of little importance. The facts were that certain benefits were to accrue to the investors in return for moneys that they paid to the company. In this sense the present circumstances meet the tests of economic realities as an investment contract, as that definition was followed in the *Great Way Merchandising* case. In my view it also meets all of the tests that were required of an investment contract as set out in the *Howey* case."

f. *Pacific Coast Coin Exchange*

Arrangements involving gold and silver coins have come up for consideration before the Ontario Securities Commission on two occasions. In the first case, *In re Pacific Coast Coin Exchange of Canada Limited*,[323] the OSC held that what was involved was an arrangement that fell within the definition of a security and issued a cease trading order. Pacific Coast Coin Exchange of Canada Ltd. was incorporated in Canada and was the agent for a company called Monex International Ltd. The commission was

320 Alberta Securities Act, s. 2(1)(27)viii.

321 Alberta Securities Act, s. 2(1)(27)xiii.

322 Attorney-General of Alberta v. Great Way Merchandising, *supra* note 316; *In re* Pacific Coast Coin Exchange of Can. Ltd., 55 D.L.R. (3d) 331 (Ont. Div'l Ct. 1975), *aff'd*, 57 D.L.R. (3d) 641 (Ont. C.A. 1976).

323 [1974] OSC Bull. 209 (November). The other case, *In re* Xantrex Management Corporation, is discussed in text accompanying notes 344, 345 *infra*.

faced with the argument that a margin contract for the purchase of silver was in essence a contract for a commodity and not a security. The commission noted that through the margin contract the investor was induced to advance money to Pacific Coast with the only security for the money being a contract called a "Current Commodity Account Agreement". The commission concluded that until the investor paid the balance owing under the margin contract, including all of the continuing and collateral charges, he stood as a creditor of Monex and subject to whatever risks were inherent in that position. Also, the commission stated that he would receive no objective information, such as that provided by a prospectus, as to the nature and extent of the risk he was asked to assume and in particular information about Monex and its assets and liabilities as well as the security being offered.

The commission noted that, although California chose to regulate this type of business through its commodity law which was a part of the corporation law of the state, other states such as Texas, Wisconsin and New York had brought actions to declare that margin contracts were investment contracts under their respective securities laws. Professor L. Loss gave testimony that the scheme of the Ontario legislation through its definition of security was to cast a wider net than at least some of the U.S. jurisdictions. In this connection, the commission referred to the definition of security under section 1(1)22.ii: "any document constituting evidence of title to or interest in the capital, assets, property, profits, earnings or royalties of any person or company". The commission also referred to the categories of documents that are exempt from the registration and prospectus requirements of the act as indicating the wide scope of the definition.

The commission held that the margin contract, subject as it was to the commodity account agreement, was a security and did not involve trading in a commodity, and stated that this view was consistent with that of Mr. Justice Hartt in *Re OSC and Brigadoon Scotch Distributors*.[324] In that case, the inducement to trade was the piece of paper, the warehouse receipt, rather than the underlying commodity; and the inducement to the investor in the present case was the leverage he could obtain by investing his available funds in the margin contract as opposed to the outright purchase of a lesser number of units with the same amount of money. The commission also said that the margin account was in addition an investment contract and therefore a security under section 1(1)22.xiii of the Ontario act.

Pacific Coast appealed the OSC cease trading order to the

324 [1970] 3 O.R. 714 (H.C.).

Divisional Court.[325] The judgment of the court was given by Houlden, J., who confirmed the commission holding that a security was involved but only on the investment contract branch of the definition. He did not find a security on the basis of section 1(1)22.ii: any document constituting evidence of title to or interest in the capital, assets, profits, earnings or royalties of any person or company.[326]

With respect to the investment contract branch of the definition, Houlden, J., referred to numerous U.S. authorities and adopted the *Howey* test, the investment of money in a common enterprise with the expectation of profit solely from the efforts of others. He found the common enterprise element present[327] since the fortunes of the purchaser depended on Pacific and the purchaser relied on the skill and success of Pacific in hedging future contracts. Any effort on the part of the purchaser was minimal, which did not take it out of the *Howey* test.[328] Houlden, J., was also prepared to adopt the risk capital test as enunciated in *State Commissioner of Securities v. Hawaii Market Center, Inc.*[329] However, most interestingly, the learned judge felt the tests used in

325 55 D.L.R. (3d) 331 (Ont. Div'l Ct. 1975).

326 With respect to this branch of the definition, Mr. Justice Houlden stated that there were two requirements to be fulfilled: first, trading in a document by Pacific, and second, that such document must constitute evidence of title to or interest in the capital, assets, property, profits, earnings or royalties of any person or company. The learned judge then stated that there was a trading in the document even though there was no right in the purchaser to assign the commodity account agreement. The learned judge felt that the fact that the contract was not assignable by a purchaser was immaterial to the question. On the second requirement, that the document constitute evidence of title, he cited the *Swain* case which held that the interest in the property does not have to be that of another person in order to come within the language of this branch of the definition of security. In other words, the fact that the Commodity Account Agreement constitutes evidence of title to or interest in the purchaser's own property does not take the arrangement out of the provisions of this clause of the definition. He also noted that the words in the act do not say any document *creating* title to or interest in capital, and so on, but any document *constituting evidence* of title. The words "any document" rebut the suggestion that the document must conform to the common conception of a security in everyday use. However, Mr. Justice Houlden concluded that the construction of the statute must not so strain the words to include cases plainly omitted from the natural meaning of the language. Although securities legislation should be construed broadly, the learned judge felt that the statutory words could not be construed to include the Commodity Account Agreement because on a fair reading of the agreement it does not constitute evidence of title to or interest in property; *id.* at 341-44.

327 Counsel for the commission cited Los Angeles Trust Deed & Mortgage Exchange v. SEC, 285 F.2d 162 (9th Cir. 1960), *cert. denied* 366 U.S. 919 (1961), which held that a common enterprise is present where the fortunes of the investor are interwoven with and dependent on the efforts and success of those seeking the investment.

328 *See* the discussion of SEC v. Glenn W. Turner Enterprises, Inc., in text accompanying note 241 *supra*.

329 485 P.2d 105 (Hawaii 1971).

the United States to interpret investment contract were too rigid and restrictive. He preferred a test, simply stated, that an investment contract was a contract or scheme for the placing of capital or laying out of money in a way intended to secure income or profit from its employment.[330]

The Court of Appeal dealt only with the investment branch of the definition and held that both by the *Howey* test and by the risk capital test, an investment contract was present.[331] The court also added that, although there was much to be said for Mr. Justice Houlden's views that the tests provided in the U.S. authorities ought not to be considered as exhaustive, it was unncesssary to determine that issue.

By a majority of eight to one (Laskin, C.J.C., dissenting), the Supreme Court of Canada dismissed the appeal and upheld the finding of the lower courts that the transactions constituted investment contracts under the Ontario Securities Act.[332] Because of the importance of the decision, it is proposed to discuss the majority and dissenting reasons in detail.

In writing the reasons for the majority, Mr. Justice de Grandpré made some important general observations. He noted that, although the Ontario act and U.S. securities legislation differed in wording, the expression "investment contract" is found in both and that the policy behind the legislation in the two countries is exactly the same, so that in considering the lack of Canadian authorities it was wise to look at decisions of the U.S. courts.[333] In this respect, he stated that the policy of the securities legislation was the protection of the public,[334] and the scope of the legislation was extremely broad as shown by the fourteen subdivisions of the definition of security, which required specific statutory exemptions to curtail the scope of the legislation.[335] As remedial legislation, the Ontario Securities Act had to be construed broadly and read in the context of the economic realities to which it is addressed; and in that connection, the substance of the transac-

330 55 D.L.R. (3d) at 347-48. Houlden, J., cites Murphy, J., in Howey, *supra* note 194, at 298. The test is reminiscent of the early attempt to define investment contract in State v. Gopher Tire & Rubber, *supra* note 211.

331 57 D.L.R. (3d) 641 (Ont. C.A. 1976).

332 *In re* Pacific Coast Coin Exchange of Canada Ltd., 18 N.R. 52 (S.C.C. 1977).

333 In fact, it was pointed out that this had already been done in Attorney-General of Alberta v. Great Way Merchandising, *supra* note 316; and *In re* Bestline Products of Canada Ltd., *supra* note 316.

334 *Citing* Hartt, J., in *In re* Brigadoon Scotch Distributors, *supra* note 308.

335 Mr. Justice de Grandpré said comments on the U.S. legislation that various categories in the definition of security are not mutually exclusive and are meant to be catchalls were also applicable to the Ontario statute; 18 N.R. at 60, *citing* 1 L. Loss at 483, 488-89, 4 L. Loss at 2501.

tion, not its form, is to be the governing factor.[336] The final general observation made by Mr. Justice de Grandpré related to the need for a flexible definition of investment contract. On this point, he adopted the approach of the U.S. Supreme Court in *Howey* which stated that, in order to fulfill the statutory purpose of compelling full and fair disclosure, it is important to have a flexible rather than static principle capable of adapting to the variable schemes which can be devised. Mr. Justice de Grandpré added that this does not mean that the legislation is aimed solely at schemes that are actually fraudulent, but rather it relates to arrangements that do not permit the buyers to know exactly what the value is of the investment they are making.

Like the lower courts, Mr. Justice de Grandpré adopted the *Howey* test to determine an investment contract. The learned judge stated that it was obvious that an investment of money had been made with an intention of profit, so that those elements of *Howey* were present. The remaining questions were whether there was a common enterprise and whether the profits were to come solely from the efforts of others. His Lordship chose to deal with these questions together, since he felt that they were so interwoven.[337]

The learned judge pointed out that "solely" as used in the *Howey* test had been criticized and modified by several decisions in the United States[338] with the result that this element meant not so much that the efforts were made *solely* by persons other than the investor, but rather that those efforts were undeniably the significant ones and the essential managerial efforts which affected the success or failure of the enterprise.

In dealing with the common enterprise element, the learned judge emphasized two aspects of the dependence of the customer upon the appellant, namely for the success of the venture and for the existence of the true market.[339]

As to the dependence of the customer for the success of the enterprise, Mr. Justice de Grandpré pointed out that the appellant in its literature underlined the danger for the ordinary investor dealing in commodity futures contracts. He stated that, although

336 *Citing* Tcherepnin v. Knight, 389 U.S. 332 (1967), discussed in text at note 202 *supra*.

337 In many cases the "common enterprise" and "profits solely from the efforts of others" are closely interwoven but they can be mutually exclusive elements.

338 Reference was made to SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476 (9th Cir. 1973); SEC v. Koscot Interplanetary, Inc., 497 F.2d 473 (5th Cir. 1974); *see* text accompanying notes 241, 252 *supra*.

339 18 N.R. at 62–63. Mr. Justice de Grandpré stated that the commonality necessary for an investment contract is that between the investor and the promoter; there is no need for the enterprise to be common to the investors "between themselves". Hence the test of common enterprise was met in his view.

the appellant attempted now to recant from that position stating that there is nothing mysterious about dealing in commodity futures contracts, both courts below refused to accept that submission, holding quite rightly that the end result of the investment made by each customer is dependent on the quality of the expertise brought to the administration of the funds obtained by the appellant from its customers. Mr. Justice de Grandpré stated that if Pacific did not properly invest the pooled deposit, the purchaser would obtain no return on his investment, regardless of the prevailing value of silver and there was nothing that the customer could do to avoid that result. This dependence was also reinforced when one looked at the margin aspect of the transaction. The purchaser could only look to Pacific for the performance of his contract, and until the investor paid the full purchase price, he had no title to any physical property, but only a claim against Pacific. Should the price of silver go down, there was no possibility for the investor to finance his balance except through his own resources, and from that moment he was at the mercy of Pacific.[340]

Mr. Justice de Grandpré pointed out that the key to the success of the venture was the efforts of the promoter alone, for a benefit that would accrue to both the investor and the promoter. Hence the nature of the relationship between Pacific and its margin customers established that it satisfied the *Howey* test; it did not matter that the relationship was built around an object that is a commodity and which in another context could be the subject matter of transactions in the futures market that would not attract the restrictions of the Ontario Securities Act.[341]

Like the courts below, Mr. Justice de Grandpré was willing to apply the risk capital test as stated in *State Commission of Securities v. Hawaii Market Center, Inc.*[342] He agreed with the Divisional Court that the risk capital approach would also bring about the same conclusion in this case. As a final word, Mr. Justice de Grandpré mentioned that he would, like the Divisional Court, be inclined to take a broader approach to these questions, since legislative policy is clearly to replace the harshness of the *caveat emptor* rule when securities transactions are involved. The courts there-

340 His Lordship agreed with the Court of Appeal observation that the matter was not a pure question of solvency since the conclusion of Houlden, J., for the Divisional Court did not rest on such a narrow basis; *id.* at 63.

341 On this point, he referred to two U.S. cases: Jenson v. Continental Financial Corporation, 404 F. Supp. 792 (D. Minn. 1975); Park v. International Silver Mint Corporation, 3 CCH Blue Sky L. Rep. ¶ 71,066 (Idaho Dist. Ct. 1972). In the Jenson case, the court said that the method of operation of the defendants transformed something that appeared to be a commodity futures contract into an investment contract.

342 485 P.2d 105 (Hawaii 1971).

fore seek to attain that goal even if judicial tests carefully formulated prove ineffective, since it is the policy and not the subsequently formulated judicial test that is decisive.[343]

Quite an opposite approach was taken by Chief Justice Laskin in his dissent. He stated that it is easy in a case like the present one, when faced with a widely approved regulatory statute embodying a policy of protection of the public against fraudulent or misleading investment schemes, to give broad, undefined terms a wide meaning so as to bring doubtful schemes within the regulatory authority. But he pointed out that if the legislature, in an area as managed and controlled as security trading, has deliberately chosen not to define a term which, admittedly, embraces different kinds of transactions of which some are innocent, and prefers to rest on generality, he saw no reason of policy why courts should be oversolicitous in resolving doubt in enlargement of the scope of statutory control.

Chief Justice Laskin in reviewing the facts stated that the purchase of the commodity account agreement gave the appellants a pool of money which became theirs and tied the customers to the appellants in the consummation of their purchases, either by taking delivery of bags of coins (which was rarely done) or by closing out their accounts by selling them at the market price through the appellants, paying a commission on selling as well as buying. The appellants controlled the so-called base price; that is, the price at which the investors bought bags of silver coins for future delivery was fixed by the appellants in relation to the then market price, which was not controlled by the appellants. Counsel for the appellants submitted that it was immaterial to the customers whether the appellants hedged or not on their future obligations to them, and that hedging concerned only the financial position of the appellants. It was only their solvency which created any risk to the customer. It was the view of the Ontario Court of Appeal that the solvency issue was not enough to bring the commodity account agreements within the scope of the Ontario Securities Act. Chief Justice Laskin understood the reluctance to find that solvency or insolvency is a determining factor, since it is equally a factor in the realization of future benefits under any commercial contract.

Chief Justice Laskin stated that what was really involved was in fact the solvency of the appellants to meet its obligations to its customers. In that respect, it would be the market that would

343 Having reached the conclusion that the commodity account agreement was an investment contract, Mr. Justice de Grandpré said there was no need to determine

determine whether and when the customer would have a profit, and he was free to close out his account and to ask for delivery *in specie* at his instance and not when the promoter chose to permit him to do so. Chief Justice Laskin did not see any controlling factor in managerial effort as the U.S. court did in *Jenson*, when in his view it is the market that determines profitability and not the promoter. The notion of managerial effort, he pointed out, came from the *Howey* case where, on the facts, the citrus grove enterprise promoted by the respondents there was managed and serviced by them. In the case at bar, there was no parallel, any more than there was with a manufacturing company whose shares are purchasable on the open market.

Chief Justice Laskin doubted that a test deriving from a particular set of facts such as those in *Howey*, or the broader risk capital approach based on another set of facts as in *Hawaii*, can or should be generalized to fix the conclusion in the different facts presented in the case at bar. In the *Howey* and *Hawaii* cases, the courts were concerned with schemes relating to land management and to merchandise selling, respectively, under which managerial control rested in the promoters. There was no substantial reliance on the market, outside of the promoter's control, as in the present case. It was apt, in Chief Justice Laskin's view, to refer to the dissent of Frankfurter, J., in the *Howey* case where he objected to bringing every innocent transaction within the scope of securities legislation simply because a perversion of them is covered by it.

It is interesting to note that although technically the only legal obligation that Pacific owed its customers was to deliver the silver when the balance of the purchase price was paid, the majority of the Supreme Court of Canada took a broader view of the situation. It emphasized the efforts of Pacific and its expertise but seemed to ignore that there was no special obligation to supply the individual customer with that expertise. On the other hand, looking at it from a substantive point of view, the customer did expect such service and expertise when it bought a commodity contract with Pacific. At the same time, it is interesting to note that the role of and efforts made by Pacific were of course subject to the market price fluctuations in silver; yet it is difficult to divorce Pacific's efforts from the market price, since both factors were involved in the question of whether or not a return would be made to Pacific and to the participants who advanced funds. In this respect, the reasoning of the majority is preferable, especially when one con-

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whether the agreement was also a security under s. 1(1)22.ii of the Ontario Securities Act; 18 N.R. at 64.

siders the policy behind securities legislation as recognized by Canadian courts in other cases.

g. *Xantrex Management*

In another case involving gold and silver bullion, the Ontario Securities Commission held that purchase orders relating to such bullion issued by a company called Xantrex Management Corporation were securities within the meaning of the Ontario Securities Act.[344] The ultimate right to the purchaser under the scheme if Xantrex failed to deliver the bullion or "repurchase" the bullion was to demand the return of his money with interest at 7% and failing that to take action against Xantrex in the courts. Although there were dissimilarities between the Xantrex scheme and the Pacific Coast arrangement, the commission felt that the comments made by it in its *Pacific Coast* decision, and indeed the observations of Mr. Justice Houlden in the Divisional Court dismissing Pacific's appeal, were applicable to the facts before the commission in Xantrex. Xantrex's counsel had cited the language of Mr. Justice Houlden in support of the proposition that the substance of this contract of Xantrex was that it was a commodity contract and emphasized dissimilarities between it and the Pacific Coast margin account. The commission held otherwise, stating on the basis of the judgment of Houlden, J., that the arrangement was an investment, and therefore a security. The commission also added that there could be a question of whether or not the contracts involved might be gaming contracts and therefore illegal.[345] As in *Pacific Coast*, a security was found even though at the centre of the arrangement lay a commodity contract.[346]

344 *In re* Xantrex Management Corporation, [1975] OSC Bull. 93 (March).

345 *Id.* at 99. The commission referred to s. 341 of the Criminal Code and cases involving commodity futures contracts executed on a commodity exchange: Beamish v. James Richardson & Sons, 49 S.C.R. 495 (1914); Maloof v. Bichell & Co., 59 S.C.R. 429 (1919); Prudential Exchange & Co. v. Edwards, [1939] S.C.R. 135. Those cases dealt with the question of whether or not the purchase of commodity futures contracts were in fact gaming contracts because the parties were anticipating a rise in the market price of the commodities forming the subject matter of the futures contracts. It was mentioned by the commission that those cases were different from the present case where the purchaser was not obliged to purchase nor the seller to deliver the physical commodity. Reference was also made to Universal Stock Exchange v. Strachan, [1896] A.C. 166 (H.L.).

346 *See also* B.C. Corporate and Financial Services Division Weekly Summary, January 10, 1975, which contained a notice from the B.C. Superintendent of Brokers dealing with investing in gold and silver bullion. The notice listed some of the risks of the "investments" and indicated that these were not fully disclosed and would be difficult for an ordinary investor to detect without the most careful inquiry. The notice also mentioned that it was a distinct possibility, "depending upon the terms of the particular contract, that the investment may be a security subject to the

h. *London Commodity Options*

In its most recent decision relating to the definition of security, the Ontario Securities Commission held that London commodity futures options and any documents or agreements based on such options were securities within the meaning of the "investment contract" and "title to or interest in assets" clauses of section 1(1)22 of the Ontario Securities Act.[347] After reviewing the nature of the agreements sold, the OSC noted that the benefit of the commodity option compared to the commodity futures contract was that, with the former, the most the investor can lose is the premium paid for the option; whereas with the futures contract, margin and margin maintenance requirements may result in major losses requiring the investor to have substantial capital to meet potential demands.[348] The OSC in arriving at its conclusion followed the decision of the Texas court in *Clayton Brokerage Co. of St. Louis, Inc. v. Mouer*.[349]

The OSC noted that the court in that case found the London options to be securities, emphasizing that the customers made no contribution toward making their investment profitable since they looked to the Clayton brokerage firm for their profit. In both the *Clayton* case and the procedures followed by the three Ontario options dealers concerning which the OSC had evidence, the recorded client on the books of the London dealer in the option was the North American dealer and not the ultimate purchaser. Moreover, whereas in the *Clayton* case the broker appeared to act as agent for its clients in London transactions, the Ontario dealers sold their own contracts to customers, relating their contracts to a London option on a futures contract with a specific price.

This aspect of the decision is most interesting because the OSC concluded that not only were the London commodity futures options "securities" but that the agreements and documents the Ontario dealers issued granting the customer rights under specified London options were also "securities".[350] The commission noted that, although the documents emanating from the Ontario dealer were similar to a confirmation in an ordinary brokerage

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provisions of the British Columbia Securities Act, and may be sold in violation of the requirements of that statute".

347 *In re* London Commodity Options, [1977] OSC Bull. 80 (April). For a discussion on commodity futures contracts and commodity futures options, *see* text accompanying note 267 ff. *supra*.

348 [1977] OSC Bull. 80 (April).

349 520 S.W.2d 802 (Tex. Ct. App. 1975).

350 *In re* London Commodity Options, *supra* note 347, at 87. The commission applied the reasoning in Brigadoon Scotch Distributors to find a security under s. 1(1)22.ii, and Howey and Pacific Coast to find an investment contract under s. 1(1)22.xiii.

transaction, there were several differences. The document did not disclose where the option was bought and at what price, the name of the dealer holding the option, or whether the Ontario dealer acted as principal or agent in the transaction. The commission stated:

> "In the language of clause ii of paragraph 22 [of section 1(1)], this is the only document [the customer] receives. It constitutes evidence of an interest in the property of the Ontario dealer amounting to an option on a commodity futures contract of specific month, year and striking price. These rights are enforceable only through and against the dealer who sold the security."[351]

In effect, then, there were two securities being sold: one by the Ontario dealers emanating from themselves, the other consisting of the options on commodity futures contracts which derived from London.[352] What is also interesting is that the OSC did not wish to relinquish applying the clause (ii) heading of the definition of security despite the holding of Houlden, J., in *Pacific Coast* that the clause was not applicable in that case on what some might argue were similar facts.

2. *Land-Related Transactions*

a. *Regina v. Dalley*

Although the sale of land or an interest in land is not normally a security, there have been arrangements involving real estate

351 *Id.*

352 Other action has been taken with respect to commodity futures options: *see* Notice by the B.C. Superintendent of Brokers in August 1975 dealing with commodity futures trading, B.C. Corporate and Financial Services Division Weekly Summary, August 15, 1975, at 1. The notice stated that a company was locating in Vancouver which intended to act as agent for a Chicago commodities broker in trading commodities futures in British Columbia. The notice cautioned that the subject of trading commodities futures and commodities options was under review to determine what would be the most appropriate form of controlling and regulating this type of activity. It was suggested that in the interim, speculators and investors inexperienced in this type of trading should consult one of the national securities firms in Vancouver having a commodities section before getting involved. The Toronto Stock Exchange in March 1974 indicated that, in view of the increased trading activity in commodity futures, and the record prices that these commodities had achieved, as well as the high risk factor in commodities trading where substantial exposure can be taken with a relatively low margin requirement, and deficient reporting requirements, a by-law had been passed by the Board of Governors requiring members to submit semi-monthly a report on all commodities futures contracts purchased and sold during the preceding 15-day period: TSE, Notice to Members: Re: Commodities Futures Trading Report (March 1974) (By-law No. 118). The Alberta Securities Commission has issued a news release stating that the commission ordered Locan Commodity Options Inc. to stop trading in alleged London commodity options in Alberta. Locan was one of the companies involved

that Canadian courts have held to be securities. In *Regina v. Dalley*,[353] the appellant had been convicted of trading in a security without registration by selling permits received from the Department of Lands and Forests of British Columbia. The permits entitled the owners to prospect and do surface geology upon the payment of fees and they received an exclusive drilling licence and ultimately a lease. The court, although not holding that the permits were securities, did say that the agreement of sale was a security since it was clearly a document constituting evidence of title to or interest in the property of the appellant. The court acknowledged that even though it would be giving a very wide meaning to the term security, where the meaning of the statute is plain, as in the case before it, the court must give effect to it. This view has been criticized, since it follows that if the agreement to sell is a security, then it would seem that a deed to land would also be a security, with the consequence that a real estate broker would be required to be registered as a security broker.[354]

b. *Avoca Apartments*

Whether a cooperative apartment suite could be considered a security came up for interpretation in *In the Matter of Avoca Apartments Limited*.[355] Under the arrangement, the ownership of each apartment suite was to be represented by shares in the capital of the cooperative company; the arrangement was described as the purchase of the exclusive right to occupy, use, and enjoy an apartment suite in the building through the ownership of shares in the capital stock of the Avoca company. Counsel for Avoca argued that, even though there was a sale and issuance of shares, the substance of the transaction was the sale of real estate; the issue of shares was only incidental and could not have been intended by the legislature to be subject to regulation by the Ontario Securities

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before the OSC in its decision of April 1977; *see* Alberta Securities Commission Summary, March 31, 1977, at 1.

353 [1957] O.W.N. 123 (C.A.); *see* the discussion of the case in text accompanying note 52 *supra*.

354 *See* J. WILLIAMSON, SUPP. at 104. As noted by Williamson, the chairman of the OSC distinguished the sale of real estate from the sale of units of participation in a real estate trust in holding the units to be securities; Parkdale Investment Syndicate, Spadina Road - Bloor Syndicate, [1958] OSC Bull. 1 (March). In R. v. Bird and International Claim Brokers Ltd., 43 W.W.R. 241 (B.C.S.C. 1963), the court held that a campaign to sell mineral claims was trading in securities under the "commonly known as a security" heading, the "constituting evidence of title" one, or the "certificate of interest in a mineral lease or claim" heading but did not say which one and did not give reasons.

355 [1968] OSC Bull. 154 (July).

Commission. The argument was that the purchaser was not buying securities which needed a prospectus, but he was buying property that he could see and inspect for himself; thus it was not necessary to obtain the protection of the OSC or of the registration and prospectus requirements of the act. Counsel for the commission argued that the legislature deliberately phrased the act in broad and general terms so that its plain wording should not be cut down by reference to supposed considerations of policy. He also argued that although there were real estate aspects to the transaction they were highly sophisticated ones in which the purchaser would require the protection of some government agency; and since there was an issue of shares involved, this pointed to regulation by the commission. The commission said that they were bound by the law as laid down in the act and did not see, after considering the opposing policy considerations, sufficient reason for departing from the literal meaning of the words used in the act.

c. *Western Ontario Credit*

In *Western Ontario Credit Corporation Limited*,[356] the Ontario Securities Commission was faced with the question whether the Securities Act applied to what were alleged to be mortgage transactions. Western Ontario Credit Corp. Ltd. (Western) and its subsidiary, WOCCO Investments Ltd. (WOCCO), carried on mortgage-related businesses. Counsel for the commission argued that the respondent companies had offered investment contracts under section 1(1)22.xiii of the definition of security and not mortgages entitling the respondents to the registration and prospectus exemption provisions under sections 19(2)4 and 58(2)a, respectively.

Under the investment plan, WOCCO guaranteed an 8% return on mortgage investments to the investor. The arrangement involved indentures, assignments, and other documents whereby WOCCO would administer and collect a mortgage on behalf of the assignees and retain all funds collected subject to its obligation to pay the principal plus interest to the investors. The investment involved a group of individuals forming one syndicate, in effect, to take a portion of the mortgage. Counsel for WOCCO argued that the OSC had to identify the document that constituted the security and that the assignment was not an investment contract but rather a mortgage within the meaning of section 19(2)4, and thus exempt from registration and prospectus provisions.

The commission ruled that the entire range of documents must be looked at before determination can be made as to what is

356 [1974] OSC Bull. 87 (May).

the investment plan or alleged investment contract. There was no single document which spelled out all the rights and obligations of the purchaser, and the particular rights and obligations which evolve are added to as one moves from one document to the next in a chronological package. The commission stated that even if one focused on the last document in the chain, that is, the assignment, it introduced terms and conditions which had not appeared before. Furthermore, the commission concluded that it is not the actual language of the document but the substance of the transaction which is relevant to the issue.[357]

After referring to various decisions, the commission concluded that an investment contract was involved, not a mortgage.[358] This conclusion derived from several features of the transaction. The proceeds to the investor were based on a rate of return set out in an "investment agreement" and not the rate of return set out in the mortgage documents. The investor had an option of investing as late as the tenth day of the month and yet received the rate of return as if he had invested on the first day of the month. WOCCO also permitted the individual investor to make payments on a periodic basis rather than in a lump sum, which was felt to be repugnant to the "notion of a contribution to and the purchase of a specific item of or interest in real property".

The commission concluded:[359]

> "Taking all of the evidence together, we conclude that the investor here was putting money out essentially to purchase the skills, expertise and administrative services of Western and the use or employment of those skills and ability to produce a guaranteed investment return. The investor was not essentially buying a specific interest in real property, *i.e.*, a mortgage."

357 In support of these conclusions the commission referred to, and applied the reasoning of, several U.S. and Canadian authorities: SEC v. W.J. Howey Co., *supra* note 194; SEC v. United Benefit Life Ins. Co., 387 U.S. 202 (1967); Tcherepnin v. Knight, *supra* note 202; Attorney-General of Alberta v. Great Way Merchandising, *supra* note 316.

358 In addition to the cases listed in note 357 *supra*, the OSC also cited with approval what it regarded as an additional test provided by the B.C. Court of Appeal in *In re* Bestline Products of Canada Ltd., 29 D.L.R. (3d) 505 (B.C.C.A. 1972), namely:

> "[T]he salient feature of securities sales is the pubiic solicitation of venture capital to be used in a business enterprise – subjecting investor's money to the risk of an enterprise over which he exercises no managerial control." [1974] OSC Bull. at 100.

359 [1974] OSC Bull. at 102. The commission noted that its conclusion was similar to that reached in Los Angeles Trust Deed & Mortgage Exchange v. SEC, *supra* note 276. Applying Attorney-General of Alberta v. Great Way Merchandising Ltd., [1971] 3 W.W.R. 133 (Alta. S.C.), the OSC characterized the investment contract as the primary or essential feature of the plan and the interest in real property as the collateral or secondary feature of the plan.

The *WOCCO* decision was affirmed by the Divisional Court which cited with approval Mr. Justice Houlden's views in *Pacific Coast* about giving a wider definition to investment contract and his opinion that the U.S. tests were too rigid and restrictive.[360] Speaking for the Divisional Court, Mr. Justice Hughes, in referring to Mr. Justice Houlden's view and the U.S. jurisprudence, said that he would have preferred the words of Frankfurter, J., in his dissenting judgment from the *Howey* case, where he said:[361]

> "Investment contract is not a term of art; it is a conception dependent upon the circumstances of a particular situation."[362]

The Divisional Court also adopted the approach taken in *Re Maher Shoes Limited and Ontario Securities Commission*,[363] in which Mr. Justice Aylesworth cautioned that where the evidence has been understood and weighed by the commission, the court should not be quick to substitute its opinion for that of the commission. Acknowledging a difference between the role of the commission in *Maher* and in the case before him, Mr. Justice Hughes nonetheless said a similar approach should be taken. The learned judge added:

> "Moreover, where a regulatory tribunal, acting within its jurisdiction, makes an order in the public interest with the experience and understanding of what that interest consists of in a specialized field accumulated over many years, the court would be especially loath to interfere. We are of the opinion that there was ample evidence to support the findings of the Commission as to the existence of an investment contract subject to the registration and prospectus provisions of the Securities Act, and that there was no misapprehension of the law applicable to the facts as found."[364]

360 9 O.R. (2d) 93 (Div'l Ct. 1975).

361 SEC v. W.J. Howey Co., 328 U.S. 293, 301 (1946).

362 *Cited in* 9 O.R. (2d) at 102.

363 [1971] 2 O.R. 267 (C.A.).

364 9 O.R. (2d) at 103. Also with respect to mortgage interests, *see* the Notice of the B.C. Superintendent of Brokers (April 20, 1977) stating the circumstances under which an exemption under the B.C. Securities Act will be granted for mortgage syndication interests. A prospectus will be required unless the following conditions are fulfilled:

> "1. where the interest in the mortgage acquired by the investor is registered 'on title' in his name or in the name of a trust company or a member of the Law Society of British Columbia in good standing as his trustee;
> "2. where there is no guarantee of return on the investment offered by the offeror; and
> "3. where the rate of interest offered to the investor is not different from that stated in the mortgage itself."

B.C. Corporate, Financial and Regulatory Services Weekly Summary, April 22, 1977, at 1.

d. *Palomar Developments Corporation*

A recent decision of the Saskatchewan District Court held that an arrangement involving the building and sale of fourplex private dwellings was not a security either under the investment contract or the profit-sharing agreement or certificate headings of security under the Saskatchewan Securities Act.[365] The accused negotiated agreements with investors to build the fourplex dwellings on land owned by the accused, and if the parties agreed the accused would proceed to register the development as a condominium. The accused had the right to sell the condominium units and receive a commission on the sales as well as sharing the net profits from the sale of the units. The accused was convicted at trial of selling securities without complying with the prospectus requirements of the Saskatchewan Securities Act. The District Court allowed the appeal stating that the building contracts did not come within the definition of security.

The result is questionable especially when one examines, with respect, the rather unsatisfactory reasoning of the court. The court dispensed with the investment contract argument based on *Great Way Merchandising* and *Bestline Products* by simply saying that those cases dealt with pyramid selling which was covered by the Combines Investigation Act. The court also said that the investment provisions of the building contracts were minor – whatever that means. In dealing with *Howey*, the court stated tersely that the case before it was not one where "American authorities" were of assistance to the court.[366] One can only hope that the decision in *Palomar* will not be followed.

3. *Franchises and Service Ventures*

a. *Century 21 Real Estate Corporation*

The B.C. Corporate and Financial Services Commission recently reviewed a franchise agreement for real estate brokers and held it was not a security under the B.C. Securities Act.[367] Under the franchise agreement, the franchisee paid an initial franchise fee and an annual service fee equal to 6% of the franchisee's gross income derived from all transactions for which a real estate licence or securities licence was required, in return for which the franchi-

365 R. v. Palomar Developments Corporation, [1977] 2 W.W.R. 331 (Sask. Dist. Ct.).

366 *Id.* at 337. The court said that a presentation of a few select U.S. cases is not of much help because of the court's lack of knowledge of the relevant legislation and other related cases.

367 *In re* Century 21 Real Estate Corporation, B.C. Corporate and Financial Services Division Weekly Summary, May 30, 1975, at 1.

see obtained the right to the use of the Century 21 system. The agreement between the franchisor (Century 21) and the franchisee provided that the latter was an independent contractor and that it was responsible for carrying on its business; however, the franchisor retained ownership and all rights, title and interest in the trade name, trademarks, goodwill and trade secrets of Century 21. The Deputy Superintendent of Brokers issued a cease trading order based on his decision that the franchise agreement constituted a security under clause (ii) of the definition of security in section 2(1) of the act, namely, "any document constituting evidence of title to or interest in capital, assets, property, profits, earnings or royalties of any person or company". At the hearing before the commission, it was also argued that the agreement fell within clause (xiv) of the definition, that is, an investment contract.

The commission acknowledged the broad approach of courts to remedial legislation like the British Columbia Securities Act citing the usual cases.[368] Also the commission noted that, if the words of the statute are broad enough in their plain meaning to cover the arrangement in issue, effect must be given to the plain meaning regardless of the consequences. However, the commission repeated the exhortation of Mr. Justice Houlden in *Pacific Coast* that the construction of a statute should not be strained to include cases plainly omitted from the natural meaning of the language.

As to the first branch of the security definition argument, the commission (acknowledging that it was not clear what the reasons of the deputy superintendent were) assumed that he viewed that the interest of Century 21 was in the earnings of the franchisee. The commission said that the deputy superintendent misunderstood the differences between "earnings" and "gross income", admitting that the terms are not precise in meaning. Since what was involved here was a percentage of gross income, the commission felt that that was similar to a rental or other cost which was incurred by a business in arriving at its net income, earnings or profits. The commission said that earnings were similar to profits and in their view the agreement in question here did not constitute evidence of any interest in either the earnings or the profits of the franchisee.[369]

368 *E.g.* Tcherepnin v. Knight, 389 U.S. 332 (1967) as approved by Canadian cases.

369 The conclusion of the B.C. commission on this point shows how easy it is for franchise promoters to avoid this heading of the definition of security since an interest in gross returns, sales, or revenues presumably falls outside the language of the heading. One also wonders whether the commission misapplied this heading in looking at an interest of the franchisor in the property of the franchisee instead of

On the question of whether the franchise was an investment contract, the commission referred to U.S. authorities as approved in the *Pacific Coast* case and others. The commission referred to the *Hawaii Market Center* risk capital analysis, in addition to the four elements of the *Howey* test. The commission approved of the wider meaning of investment contract that Mr. Justice Houlden in *Pacific Coast* preferred to give the term, and felt that this view had considerable merit; the danger with the risk capital analysis was that it invited the same sort of semantic and mechanical response by promoters as that evoked by the *Howey* formula.

However, the commission stated that even on Mr. Justice Houlden's broad interpretation the agreement in issue did not constitute an investment contract. Although the franchisee expected to profit from the laying out of money or the placing of capital in the form of franchise and service fees, this was literally true of contracts for the purchase of goods for resale. The commission noted that a retailer must pay a wholesaler money to acquire goods for resale to the public at a profit. In this sense, literally applying Mr. Justice Houlden's wider meaning, a contract of sale would constitute an investment contract, and to do this in the context of the British Columbia Securities Act definition would disregard substance for form and ignore economic reality. In the opinion of the commission, what took a sale out of the scope of investment contracts for the purposes of the British Columbia Securities Act was the fact that the price the purchaser paid for the goods did not, quoting the judgment of *Hawaii Market Center*,[370] "subject it to the risks of enterprise" of the vendor.

Thus the commission thought that the sale of a commodity was similar to the sale of the franchise for which the franchisee pays a sum of money. Upon payment, he loses all title to or interest in that money. Consideration in the form of the franchise and service fees become the absolute property of the franchisor to be disposed of by Century 21 in whatever way it is thought most appropriate, and the franchisee has no residual claim on the money thus paid over. Should Century 21 go into solvent liquidation, the franchisee will have no claim in the liquidation against any of the assets of Century 21. Furthermore, should Century 21 suffer trading losses, the franchisee will not suffer at all. If Century 21 makes profits, then no part of the profits will redound to the benefit of the franchisee. In other words, the commission stated that the profits the franchisee will make will come from its own efforts in exploit-

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vice versa. It would seem that the investment contract analysis is more appropriate for arrangements like franchises.

370 485 P.2d 105 (Hawaii 1971).

ing the Century 21 system in exactly the same way that the profits of a retail distributor come from its efforts in selling merchandise bought from a wholesale supplier.

In short, Century 21 was offering its system for sale and in doing that was carrying on its business and not investing in the business of the franchisee. The commission did say, however, that it did not feel its conclusion that the disputed franchise agreement was not an investment contract meant that in every case a franchise agreement was necessarily beyond the scope of the definition of a security.

b. *Re Sanderson*

A rather novel service contract was at issue in *Re Sanderson and Ontario Securities Commission*[371] in which the Ontario Court of Appeal held that a betting arrangement was an investment contract. Under a contract, individuals deposited $400 to be bet on horseraces by one Sandy Sanderson who styled himself as "an old pro". An individual was told that he would get $75 a week for sixteen weeks, netting him a profit of $720. The lower court held that no security was involved.

The respondent argued *inter alia* that the document in question was not a security within the meaning of the Ontario Securities Act. The Court of Appeal reversed the decision of the lower court and held that there was in fact a security within the branch of the definition which provides that any income or annuity contract not issued by an insurance company or an issuer within the meaning of the Ontario Investment Contracts Act is a security.[372] Unfortunately, the judgment is not supported by any reasoning – it is quite simply stated that the court was satisfied that the document in question was in the nature of an income contract and all parties had agreed that it did not come within the Investment Contracts Act.[373]

There are other instances of service-oriented arrangements which have attracted the attention of securities administrators; hence this type of scheme can be quite problematic.[374]

371 [1972] 3 O.R. 329, 28 D.L.R. (3d) 171 (C.A.).

372 Ontario Securities Act, s. 1 (1)22.xii.

373 For an interesting epilogue to Sandy Sanderson *see* D. JOHNSTON at 32 n. 79.

374 *See* the Notice, dated June 17, 1975, in which the B.C. Superintendent of Brokers noted recent advertisements for the sale of so-called vacation licences, vacation time sharing agreements or the like and stated they are considered to be securities within the meaning of the Securities Act. The superintendent proposed to require the filing of a prospectus in compliance with the Securities Act to ensure that full, true, and plain disclosure be made by those distributing or proposing to distribute these securities. The notice also cautioned the public to insist on the production and careful perusal of a duly filed prospectus prior to purchasing any such licence or

4. *Pyramid Ventures or Distributorships*

a. *Great Way Merchandising*

In *Attorney-General of Alberta v. Great Way Merchandising Ltd.*,[375] the Appellate Division of the Alberta Supreme Court dismissed an appeal against the finding that the appellant had traded in securities while not being registered as a broker or otherwise under the Alberta Securities Act. The appellant proposed to establish a retail discount store, and it used in its promotion campaign an agreement called an "Authorized Representatives Agreement" with the aim of recruiting a maximum of 3,000 representatives who in turn would recruit up to fifty potential customers of the store. A representative on his recruitment paid a sum of money to the appellant, some of which was to be used to purchase stock in trade for the store and some of which was to be retained by the appellant. In return for his payment, the representative was given, under the agreement, rights to earn money in various ways, including commissions on store sales made to customers recruited by him. The question was whether the Authorized Representatives Agreement constituted a security within the meaning of the Alberta Securities Act.

The court held that the agreement clearly contained provisions for investment and a promise or expectation of a return to the investor. In the court's view, it did not matter that intermingled with such provisions in the agreement were others which dealt with non-investment matters, because such intermingling did not rob the agreement of its essential character as an investment contract; and this element was a substantial, if not the predominant, characteristic of the document, which thereby made it come within the definition of a security in the act.[376]

The principal argument made was that the agreement was an investment contract. Mr. Justice McDermid, in giving the judgment of the court, cited Chief Justice Stout in *Commissioner of*

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agreement; B.C. Corporate and Financial Services Division Weekly Summary, June 20, 1975, at 1. In this connnection, *see* the decision of the Deputy Superintendent of Brokers of B.C., *In re* Securities Act and Leisure World Enterprises Ltd., B.C. Corporate and Financial Services Division Weekly Summary, November 15, 1974. The deputy superintendent held that a vacation scheme which comprised, among other features, an instructional course and a share participation in the promoter was a security within the meaning of the definition under the B.C. Securities Act.

375 [1971] 3 W.W.R. 133 (Alta. S.C.).

376 It is interesting to note that a specific term of the Authorized Representatives Agreement provided that the agreement or other document was not in any way to be considered a security.

Taxes v. Australian Mutual Providence Society,[377] where investment was defined by referring to its dictionary meaning of the laying out of money or putting out capital for the purpose of obtaining interest for it. Mr. Justice McDermid also stated that the Alberta Securities Act was remedial legislation and should be interpreted as such and that it did not absolutely prohibit transactions such as the one at bar but required that they be approved first for the public protection. He also noted that the investment of monies in this case was a substantial, if not the predominant, element in the arrangement but that there could be an arrangement where the investment provisions were so minor and so submerged in non-investment provisions that in essence the resulting contract would not be an investment security as provided in the act.

Mr. Justice McDermid referred to the *Howey* case and cited the test and approach of the court in that case relating to form being disregarded for substance and the emphasis on economic reality. Counsel for Great Way had urged that the test of *Howey* was not met because the individual earned money on a commission basis; hence the effort did not come from Great Way but rather from the individual concerned so that the "solely on the efforts of others" element was not present. Mr. Justice McDermid replied that he did not think the *Howey* case was authority for the proposition that, by a combination of non-investment terms with investment terms, the resulting contract ceases to be subject to the Alberta Securities Act.[378]

Mr. Justice McDermid concluded that it was unnecessary, in view of his holding, to decide whether the arrangement was a security under clause (ii) ("any document constituting evidence of title to or interest in capital, assets....") or clause (viii) ("any profit-sharing agreement or certificate") of the Alberta Securities Act definition of a security.

b. *Bestline Products*

Another pyramid sale arrangement came up for consideration in *Bestline Products v. British Columbia Securities Commission*[379] which was initially decided by Mr. Justice Aikins in chambers not to be an investment contract. The British Columbia Securities Commission had issued an order prohibiting the applicant's sales organization from recruiting others into its sales force

377 22 N.Z.L.R. 445 (C.A. 1903).

378 Mr. Justice McDermid referred to other U.S. cases dealing with similar distributorship arrangements which went different ways on the question. [1971] 3 W.W.R. at 148.

379 [1972] 2 W.W.R. 287 (B.C.S.C.).

on the ground that the recruitment amounted to the sale of a security. The business of the applicant was selling cleaning materials directly to the public and its sales organization consisted of three levels of salesmen: local distributors, who sold the applicant's products to the public from door to door; direct distributors, who managed and controlled the local distributors and provided them with merchandise to sell; and general distributors, who trained and generally controlled the direct distributors. One could progress from one level of distributorship to the next. The returns were by way of commission based on the efforts of the entire sales force. To become a direct distributor, some $2,000 had to be paid, the bulk of which went to the purchase of the applicant's merchandise and the remainder to the purchase of a training kit and membership in the organization. There was no guarantee that the purchaser would receive any benefits from the money paid; the purchaser could earn benefits only through his own efforts. The argument was made that the opportunities for making money as a direct distributor made the sale of such distributorships the sale of a security within the investment contract branch of the definition of security.

Mr. Justice Aikins held that there was no investment in the applicant company since the money that was paid was for clearly defined things, namely, cleaning material for sale, the sales kit, and the membership in the applicant's organization. There was therefore no investment and any money made by the purchaser of a direct distributorship was made solely as a result of the purchaser's own efforts.[380]

This decision was confirmed by the B.C. Court of Appeal.[381] Mr. Justice Nemetz cited the *Great Way* case and the U.S. cases that were referred to in *Great Way* which went opposite ways on the question of interpreting pyramid sale arrangements. Mr. Justice Nemetz adopted the view of Mr. Justice McDermid in *Great Way* on the latter's interpretation of the *Howey* case relating to the combination of non-investment terms with investment terms in the contracts under dispute. He noted that in *Great Way* there was an actual investment made in the store and stock owned by the company; in other words, an investment ingredient was proved and, accordingly, the court was able to bring the scheme under the Alberta Securities Act. Mr. Justice Nemetz said that the Crown was not able to show that the sum of $2,000 paid by a direct distributor to Bestline was anything other than the purchase for

380 Mr. Justice Aikins also ruled that the distributorship was not "any document, instrument or writing commonly known as a security" under s. 2 of the B.C. Securities Act. However, no reasons were cited for this conclusion; *id.* at 294.

381 [1972] 6 W.W.R. 245 (B.C.C.A.).

value of the cleaning materials, plus other legitimate merchandising charges. The situation would have been entirely different, in his view, if it had been proved that the sum of $2,000 did not represent a purchase for value. In those circumstances it might be inferred that an investment ingredient existed. The Crown was unable to show, even though it asserted that the distributor received a "bundle of opportunities", that Bestline received any consideration for the opportunities so received. The learned judge also said that, although the direct distributors placed sums of money in trust with Bestline in order to become general distributors, it was not shown that Bestline received that money. In fact, he said, to the contrary, the evidence was that the bulk of it went to other general distributors and the remainder to provide transportation and accommodation for the direct distributor when he visited another city to receive further merchandising instructions.

At the conclusion of his judgment, Mr. Justice Nemetz cited and adopted the risk capital test from *Hawaii Market Center*[382] to ascertain whether a selling scheme is a security.[383] However, he concluded with no discussion that the Crown failed to prove that the present facts came within the *Hawaii Market Center* criteria.[384]

Chapter VI
Summary and Recommendations

A. INTRODUCTION

The foregoing chapters have dealt with the scope of the U.S. and Canadian securities legislation, and this chapter contains a brief summary of the basic definitions followed by some recommendations. The recommendations deal primarily with the definition of "security", but reference will also be made to related definitions and the question of exemptions generally. It is important to note that the definitions of security and related terms and the nature of the exemptions relate to the overall approaches toward securities regulation desired for a particular securities act. Thus the objectives of the act must be specified first, followed by how those objectives are to be attained.

382 485 P.2d 105 (Hawaii 1971), discussed in text accompanying note 231 *supra*.

383 [1972] 6 W.W.R. at 250.

384 Separate reasons for dismissing the appeal were given by Tysoe, J.A., with whom Maclean, J.A., concurred; *id.* at 246.

B. THE DEFINITION OF SECURITY

1. *Summary of Canadian Legislative Provisions*

Several conclusions emerge from an examination of the definitions of security in Canadian securities legislation.[385] First, although important differences exist, the general thrust of the definition is similar among the various provincial jurisdictions. Second, a security is broadly defined with branches of the definition having a very wide scope,[386] supplemented by branches with a very narrow or specialized meaning.[387] Third, much overlap appears to be present and some types of securities, notably those relating to oil and gas, are not clearly delineated. In fact, the definition of a security has been described as a "heterogeneous clutter".[388] Fourth, the approach taken among the various Canadian securities statutes has been to define security in the act *and* the regulations promulgated thereunder.[389] Finally, the definitions of security have been influenced by the development of the securities laws of the United States both at the state and federal levels.

2. *Summary of Canadian Interpretations of Security*

In comparison with the United States experience, there have been relatively few examples of interpretations of the definition of security by either Canadian courts or securities administrators.[390] However, some important principles can be gleaned from the decisions we have.

Courts and administrators in interpreting security have emphasized the underlying purposes or objectives of securities regulation, for example, the protection of the investing public.[391] In addition, the interpreters of security have also stated that, in

385 *See* discussion in text accompanying notes 49-70 *supra*.

386 *E.g.* "investment contract"; "any document constituting evidence of title to or interest in the capital, assets, property, profits, earnings or royalties of any person or company".

387 *E.g.* interests in scholarship or educational plans or trusts in Ontario Securities Act, s. 1(1)22.xiv; and certain agreements to purchase fur-bearing animals, which heading is found in the regulations under the securities statutes of New Brunswick, Newfoundland, Nova Scotia and Prince Edward Island.

388 J. WILLIAMSON, SUPP. at 100. Williamson adds: "To some extent, the defining terms seem to have been added piecemeal, and without much justification"; *id.*

389 *See generally* New Brunswick, Nova Scotia, Prince Edward Island and Newfoundland Securities Acts.

390 *See generally* ch. V *supra*.

391 *E.g. In re* Brigadoon Scotch Distributors, *supra* note 308 (*per* Hartt, J.), discussed in text accompanying notes 308, 309 *supra*.

reviewing the myriad of transactions or arrangements alleged to be securities, substance not form should govern.[392]

Although some of the earlier holdings of a security were based on the "evidence of title to or interest in the capital, assets, property...of any person" heading, recent Canadian cases have focused on the meaning of "document, instrument or writing commonly known as a security"[393] and more particularly the meaning of "investment contract".[394] With respect to the latter term, the Canadian courts and securities administrators have referred to and adopted well-established U.S. tests and analyses, notably the U.S. Supreme Court's decision in *Howey* [395] and the risk capital approach of the California Supreme Court's decision in *Silver Hills*.[396]

Like their U.S. counterparts, the Canadian judges and securities administrators have looked not only at what was being sold but also *how* the arrangement or transaction was set up. If property or service alone was involved, then a security was not present; if more than the sale of property or service was involved, a security was present. In this connection emphasis has been placed on the policy of the securities act and whether the arrangement or transaction was basically of an "investment" or "commercial" nature, with only the former attracting the requirements of the securities act.[397] It is also interesting that one Canadian judgment was prepared to go even further than the U.S. tests of *Howey* and *Silver Hills* in order to apply a less rigid and restrictive test for an investment contract by defining the term as a contract or scheme for the placing of capital or laying out of money in a way intended to secure income or profit from its employment.[398] At the same time, the judgment recognized the general principle of statutory interpretation that the construction of the securities act should

392 *E.g. In re* Farmex Enterprises, *supra* note 314, discussed in text accompanying notes 314-16 *supra*; Attorney-General of Alberta v. Great Way Merchandising Ltd., *supra* note 316; *In re* Bestline Products Ltd., *supra* note 316.

393 *In re* John T. Geldermann, *supra* note 310, discussed in text accompanying notes 310-13 *supra*.

394 Notably the Supreme Court of Canada in *In re* Pacific Coast Coin Exchange, 18 N.R. 52 (S.C.C. 1977).

395 328 U.S. 293 (1946), discussed in text accompanying notes 194-95 *supra*.

396 55 Cal. 2d 811, 361 P.2d 906 (1961), discussed in text accompanying notes 216-24 *supra*.

397 *See In re* Brigadoon Scotch Distributors, *supra* note 309 (*per* Hartt, J.).

398 *In re* Pacific Coast Coin Exchange, *supra* note 323 (*per* Houlden, J.). The Supreme Court of Canada approved of Houlden, J.'s views; *see* text accompanying note 341, *supra*. *See also* the approval given by the B.C. Securities Commission in *In re* Century 21 Real Estate Corporation, *supra* note 367, discussed in text accompanying notes 367-69 *supra*.

not be strained to include cases plainly omitted from the natural meaning of the language employed.[399]

As a general comment, the Canadian decisions, especially the recent ones, have for the most part been well reasoned and have reached the right results.[400] As a consequence, entrepreneurs and their legal advisers are now in a better position because of the jurisprudence to predict whether a particular transaction or arrangement is likely to be regarded as a security.

3. *Recommendations*

a. *General: Influencing Factors*

As previously discussed,[401] a number of factors directly influence the definition of security in a securities act. These are: the importance of having a definition which meets the objectives of the securities act and which fits the approaches taken to achieve those objectives; [402] the need for a flexible yet reasonably certain definition which meets new devices used to attract investors, but which is not so broad as to introduce unnecessary regulation or duplicate regulation effected other than through the securities act; and the desirability of uniformity of legislation because securities cross provincial and indeed international boundaries with relative ease.

The broad approach of the present statutory provisions relating to securities is worth adopting, although specific recommendations discussed below should improve the clarity of the coverage of the definition by reducing duplication. The broad scope of the present definitions has not proved to be unworkable especially since the Canadian legislation rightly provides for a fairly comprehensive list of exemptions as well as a power to exempt securities or transactions by regulation.[403]

b. *Specific Recommendations*

i. *Evidence of a Security and Interests Therein*

As can be seen from the provincial acts, most branches of the definition of security speak of the written instrument or document as the security.[404] It is recommended that the definition of

399 *See* the discussion of this point in *In re* Century 21 Real Estate Corporation, *supra* note 367.

400 A notable exception is *In re* Palomar Developments Corporation, *supra* note 365.

401 *See* text accompanying notes 1–4 *supra*.

402 *See* text accompanying notes 1–3 *supra*.

403 *See* text accompanying notes 92–134 *supra* for a discussion of exemptions.

404 Certain branches do, however, mention an interest; *see e.g.* Ontario Securities Act,

security include a reference to not only the written instrument or document but also to any interest therein to prevent a possible loophole.[405] In this connection, the right to acquire or sell a security should also be specifically mentioned in the definition of a security.

ii. *Any Document, Instrument or Writing Commonly Known as a Security*

Although this heading of the definition has not been referred to as often in the Canadian cases[406] the wording is necessary if only as a prospective tool to catch novel types of documents which become known as securities.

iii. *Any Investment Contract*

As illustrated by the discussion in chapters IV and V of this paper, "investment contract" has been the phrase of the definition of security which has received the most attention from the courts and securities administrators. There is no question that the phrase should appear in the definition of security. But should the words "investment contract" themselves be defined in the statute to give greater certainty and precision to the scope of the statute? Several commentators have suggested definitions of investment contract based on their analyses of the statutory objectives and the cases interpreting the phrase.[406a] The *ALI Federal Securities Code* does not define the term[407] and this omission has been criticized as disappointing.[408]

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s. 1(1)22.x ("any oil or natural gas royalties or leases or fractional or other interest therein").

405 *See* J. WILLIAMSON, SUPP. at 102; text accompanying note 50 *supra*.

406 *But see In re* John T. Geldermann, *supra* note 310.

406a *See* Professor Coffey's suggestions *cited in* text accompanying notes 227-29 *supra*; Professor Long's proposal *cited in* text accompanying note 230 *supra*.

407 ALI FEDERAL SECURITIES CODE, Reporter's Revision of Tent. Drafts Nos. 1-3, s. 297.

408 Hannan & Thomas, *supra* note 11, at 230. It is interesting that Australian state legislation defines investment contract in the Securities Industry Acts, 1975, by incorporating the definition of investment contract found in s. 76 of the Companies Acts. Section 76(1) of that act defines investment contract in the following terms:

> " 'Investment contract' means any contract scheme or arrangement which in substance and irrespective of the form thereof involves the investment of money in or under such circumstances that the investor acquires or may acquire an interest in or right in respect of property whether in the State or elsewhere which under or in accordance with the terms of investment will, or may at the option of the investor, be used or employed in common with any other interest in or right in respect of property whether in the State or elsewhere acquired in or under like circumstances."

See e.g. Companies Act 1961, Victoria Acts of Parliament, 10 Eliz. 2, No. 6839; Securities Industry Act 1975, Victoria Acts of Parliament, No. 8788. For a recent

It is recommended that investment contract not be defined in the statute for several reasons. First, the general tests which have been offered are themselves capable of wide interpretation and some ambiguity, to the extent that one wonders what really is gained by trying to define investment contract. Second, the decisions of the courts and securities administrators (admittedly borrowing from U.S. experience) have shown an increasing familiarity with the term, and the results to date provide reasonable guidance to promoters and lawyers on what is or is not an investment contract. A good example is the decision of the Supreme Court of Canada in *Pacific Coast Coin Exchange*. Finally, uniformity among the provincial statutes – especially in basic definitions such as that of a security – is extremely important, and so a definition of investment contract should probably await further experience and consultation among the various jurisdictions in Canada.

With the expansive interpretation of "investment contract", it is questionable whether a number of headings found at present in the definition of "security" are really necessary. Most notable is the following heading:

> "any document constituting evidence of title to or interest in the capital, assets, property, profits, earnings, or royalties of another person."[409]

This heading has also been described as too broad and uncertain for inclusion in a securities act and should probably be rejected on that basis.[410]

iv. *Specific Types of Securities*

The provincial securities statutes list various types of securities which are specifically included as illustrative of the definition of security. It is recommended that these be adopted; however, a more logical grouping of these securities should also be made. The types of securities recommended are:

(1) any bond, debenture, note or other evidence of indebtedness,[411]

decision interpreting the definition, *see* Waldron v. Auer, 2 CCH Aust. Corp. Affairs Rep. ¶ 40-314 (S. Ct. Vict. 1977).

409 *See* text accompanying note 51 ff. *supra.*

410 As noted above, J. Williamson, Supp. at 105 correctly criticizes the heading as too broad. If one examines the decisions which have applied this branch of the definition (*e.g. In re* Brigadoon Scotch Distributors, *supra* note 308) the investment contract heading could have been easily used to be the basis for holding that a security was involved.

411 It might be worthwhile to consider excluding such things as cheques, currency, drafts and bills of exchange as is done in the ALI Federal Securities Code, Reporter's Revision of Tent. Drafts Nos. 1-3, s. 297 (b) (definition of a security). In

(2) any share, stock, unit, unit certificate, participation certificate or certificate of share or interest,
(3) any preorganization certificate or subscription,
(4) any agreement under which the interest of the purchaser is valued for purposes of conversion or surrender by reference to the value of a proportionate interest in a specified portfolio of assets,[412]
(5) any interest in, or document constituting evidence of an interest or participation in,
(a) a profit-sharing agreement
(b) a trust, estate or association, or
(c) an oil, natural gas or mining lease, claim or royalty or other mineral right,
(6) any collateral trust certificate.

To the above should be added the following new specific types of security which are listed in the *ALI Federal Securities Code*:[413]

(7) any voting trust certificate,
(8) any equipment trust certificate.

It is hoped that the above enumeration of specific types of security will be an improvement, for example, over the various oil and gas interests now in the provincial acts.[414] In addition, the heading "any preorganization certificate or subscription" probably eliminates the need to retain a separate heading dealing with:

> "any agreement providing that money received will be repaid or treated as a subscription to shares, stock, units or interests at the option of the recipient or of any person...."[414a]

It should be mentioned that the foregoing types of securities do not include such items as "any document constituting evidence of an interest in a scholarship or educational plan or trust"[415] or other types of specific securities which have been recently added to the definition of security in the provincial acts.[416] Such particular items would be covered by the expansive definition of invest-

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this connection, reference should be made to Bank of Canada v. Bank of Montreal, 76 D.L.R. (3d) 385 (S.C.C. 1977) which upheld the conclusion that banknotes were promissory notes within the meaning of the Bills of Exchange Act, R.S.C. 1970, c. B-5.

412 This heading was added by Ontario's Bill 30 to cover variable annuity contracts; *see* text accompanying notes 142, 143 *supra*.

413 ALI Federal Securities Code, Reporter's Revision of Tent. Drafts Nos. 1–3, s. 297

414 *See* the discussion in text accompanying notes 58–60 *supra*.

414a *See* text accompanying note 57 *supra*.

415 Ontario Securities Act, s. 1(1)22.xiv.

416 *See e.g.* Ontario Bill 30, s. 1(1)38.xv. This heading lists rights to use real property for residential, recreation or vacation purposes; *see* text accompanying note 144 *supra*.

ment contract and should be so announced from time to time, as these new devices appear, by the appropriate securities administrator or commission under the securities act.

C. RELATED MATTERS: THE DEFINITIONS OF TRADE AND DISTRIBUTION AND EXEMPTIONS

As stated above,[417] the definition of trade in the Ontario Securities Act is fairly broadly drawn to include a great number of acts and transactions. The definition of trade in Ontario's Bill 30 makes it clear that a purchase is not included as a trade, although this can give rise to problems in other areas of the statute.[418] The breadth of definition is important to adopt, and it would appear that some parts of the act would require that both the sale and purchase sides of trade be included.[419]

The definition of distribution and the exemptions (for securities or transactions, or by commission order) depend on the securities statute's particular scheme of regulation. These matters were briefly discussed in dealing with the present Ontario Securities Act[420] and the proposed treatment of these subjects under Ontario Bill 30.[421] No specific recommendations will be made on these matters, but the general rationale for the exemptions should be recognized in any proposed securities act and these have also been discussed previously.[422] In addition, the commission should also be given wide exempting powers.[423] Finally, it should be remembered that, although securities or transactions may be exempt from certain aspects of regulation under the statute, they nonetheless should not be exempt from other measures such as the anti-fraud provisions.[424]

417 *See* text accompanying note 71 ff. *supra.*

418 *E.g.* in the takeover provisions which involve a purchase; *see* discussion in note 73 *supra.*

419 This is in fact the case in the ALI FEDERAL SECURITIES CODE, Reporter's Revision of Tent. Drafts Nos. 1-3, ss. 283, 293.

420 For the discussion on "distribution to the public" in the present Ontario Securities Act, *see* text accompanying note 83 ff. *supra*; for the discussion on the various exemptions under the present Ontario Securities Act, *see* text accompanying note 92 ff. *supra.*

421 For the discussion on "distribution" under Ontario Bill 30, *see* text accompanying note 151 ff. *supra.* For the discussion of the various exemptions under Ontario Bill 30, *see* text accompanying note 154 ff. *supra.*

422 *See* text accompanying note 96 *supra.*

423 As is done in the ALI FEDERAL SECURITIES CODE, Reporter's Revision of Tent. Drafts Nos. 1-3, s. 302.

424 *See* the discussion under the U.S. legislation in text accompanying notes 37, 42a *supra.*

Disclosure Requirements

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September 1976

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Chapter I
Preface

This report has been prepared at the request of Consumer and Corporate Affairs Canada as one of the background studies conducted under the auspices of that department to assist in decisions as to a federal securities law for Canada. The scope of the report, while wide-ranging, has been limited in certain areas because of our understanding that these areas are being dealt with by others; for example we have dealt only peripherally with insider trading, with takeover bids and with the entire question of remedies, although all of these topics relate directly to those which are discussed. Some modification of the recommendations in this or in other reports might be necessary to arrive at a workable integrated disclosure pattern.

Even more than other topics in the fertile area of securities regulation, disclosure has been a well-tilled field during the past decade. In Canada, in the United States and elsewhere major studies have been undertaken and substantial legislative and

Our sincere thanks are due to our secretaries, Barbara Persaud and Mary Green, who not only typed our manuscripts, corrected our errors and managed to keep us in frequent communication but who also came up with a good sense of humour when all else failed. We also acknowledge the assistance of our research student, Peter Stein, who laboriously dug out literally hundreds of articles for us to consider, and Philip Anisman, the overall project coordinator, who sent us many helpful references.

regulatory changes made. Our instructions were, in essence, to review the existing and proposed requirements in this country and elsewhere and to propose an integrated disclosure system appropriate for adoption at the federal level in Canada. In so doing, we have supported most of the principles upon which existing law is based but recommend a number of changes of detail. In some cases, these details deviate significantly from existing law and may well prove controversial. That is appropriate, for this paper reflects nothing more than the judgment of the two writers.

One point should be stressed, for it has shaped our approach to the writing of this paper. This is that certain premises are assumed and hence do not require consideration. Since some of the premises may be even more controversial than the recommendations in the paper, it is helpful to refer to them here. (A more detailed statement appears in chapter VII.) We have assumed in the preparation of this report that Parliament is to adopt a federal securities statute and that it is within the constitutional authority of Parliament to deal in that statute with all of the topics traditionally encompassed by securities regulation. While we make no assumptions as to whether provincial securities regulation will continue in effect, we do assume that Parliament is to adopt the best possible system even if it is not congruent with the requirements of present provincial law.

These assumptions have had a significant impact upon the report. Yet at least some of them may be open to serious question. We do not purport to make political judgments or to predict provincial reaction to a federal initiative, but we must recognize the possibility that provincial regulation will continue in effect after the adoption of federal regulation. If the federal regulation were to reflect the recommendations in this report, substantial confusion and inconvenience to all affected by securities regulation would result unless the continuing provincial regulation was made uniform with the federal requirements. Further, arrangements for interjurisdictional cooperation would be necessary to attain uniformity in the exercise of discretionary powers and to avoid having the federal authority as simply an additional level to which applications must be made.

While we believe that implementation of the recommendations in this report would result in an improvement on present law, we do not believe that the improvement would be so great as to justify the chaos that would result if interjurisdictional uniformity and administrative arrangements did not accompany the new rules. Of course, the situation might not be so black and white in practice; each jurisdiction involved might take some steps towards uniformity and adequate administrative arrangements without

fully attaining these objectives. While we recognize that each situation must be analyzed on its merits, we trust that all concerned will accord priority to arriving at a workable regulatory pattern. The system currently in effect contains no deficiencies so glaring as to necessitate federal involvement to impose a different system. In our view it would be better for the federal government simply to adopt existing provincial legislation, changing the names where necessary, rather than to add extra complications for the sake of a slightly improved system which would not integrate with provincial systems that were to remain in force.

Chapter II
Historical Analysis

It is useful to research earlier materials if one is to make suggestions for new legislation because the modes of effectively regulating the conduct of human beings, which is the primary object of legislation, have been relatively constant. Some insight into what is necessary and feasible, particulary in disclosure requirements imposed on business enterprises, can be gained by considering previously enacted requirements, their successes and failures. Thus if one were to find that the introduction of legislation imposing large penalties had eliminated most fraudulent schemes, one would be inclined to recommend stiff penalties against fraud. On the other hand, if the fraudulent schemes continued unabated despite such legislation, other methods of regulation would be proposed.

It would be impossible in this paper to attempt a complete historical survey of the regulations requiring disclosure by business enterprises which have significant contact with the public. Indeed even if the field is narrowed to public corporations, the task is still enormous as such corporations cover many different kinds of business organizations which, depending on their importance to the economy or the jurisdiction involved at the time of analysis, were subjected to various forms of required disclosure. Categories such as canal companies, railway companies, banks and insurance companies have historically been subject to extensive governmental regulation which presupposes some disclosure. Accordingly, we have only attempted to canvass some of the concepts developed in earlier periods which we believe may be of some use today. In so doing we have found that the disclosure requirements had four different sources:

(1) requirements set forth in statutes or other emanations of governments, federal or provincial;

(2) requirements set forth by self-regulatory associations such as the stock exchanges;
(3) requirements set forth by the corporations themselves, usually in the constating documents;
(4) requirements developed because of judicial decisions imposing some form of liability in the absence of disclosure.

Each of these four sources has been important to a greater or lesser degree in each area of disclosure relevant to securities regulation. Broadly speaking those areas include both disclosures made by public corporations concerning their own activities (whether on a periodic basis or at the time of an initial issue of securities or at the time of significant changes such as amalgamations) and disclosures related to secondary market activity in the corporations' securities (whether for the account of the corporations themselves, insiders of the corporations, securities dealers or financial intermediaries). Our historical survey has been limited to England and the United States of America,[1] as these are the jurisdictions which have long traditions in establishing regulatory systems in the economic arena. In 1974 Australia introduced but has not yet enacted draft federal legislation in the field; reference to the Australian proposals will be confined to later parts of this paper.

In any survey of the history of disclosure in the United States and England, one must be conscious of the different political institutions in the two countries. England is a unitary jurisdiction whose legislative requirements for corporate disclosure have been embodied in the Companies Act. Broadly speaking, at least until recently, unincorporated or foreign enterprises had to satisfy no statutory disclosure requirements of a general character at all. On the other hand the United States is a federation in which the constitutional division of powers is such that the central government, except in a few specified areas, has no mandate to incorporate companies and has no equivalent to a Companies Act in which it could include disclosure requirements. Originally such requirements in the United States were contained in state corporate legislation. The enormous advance to federal disclosure legislation was not undertaken until the economic chaos of the late 1920s and early 1930s forced the government to reexamine the whole structure of the securities industry in much the same way, if not with the same result, that England reexamined the industry after the South Sea Bubble. Even at the state level the disclosure require-

1 France, for example, has only recently embarked on any disclosure regime; *see* Beaman, *Disclosure Requirements in France*, 12 VA. J. INT'L L. 358 (1972). Indeed

ments had been separated from the general incorporating statutes in the early years of the twentieth century, presumably because of the simplicity of avoiding corporate law restrictions by jurisdiction shopping for corporate charters. This is an important point as it indicates the futility of confining securities legislation in a federal jurisdiction to corporations of a particular jurisdiction. It would be foolish to confine federal disclosure requirements in Canada to federal companies.

It is also important to note that the concept of a general incorporation law, as opposed to incorporation by special act or by the exercise of the royal prerogative, developed earlier in the United States than it did in England. While there is some quibble in the literature as to what constitutes a "general" incorporation statute, the consensus seems to be that the New York statute of 1811 is the first modern statute. It has even been claimed that the English Act of 1844 was modelled on the New York Statute.[2] The reason why the United States developed general incorporating statutes before England may be attributable to the absence of a royal prerogative after the American revolution. In addition, there was and is a widespread belief in the United States that incorporation by special act is inappropriate.[3] Thus while England or Canada could require disclosure for major institutions incorporated by special act or royal prerogative within the incorporating statute or document itself, the United States was forced to think in terms of more general disclosure requirements.

A. THE EARLY PERIOD

Perhaps the earliest business corporations in England were the merchant guilds, which were chartered, or guildated (which was synonymous with "incorporated" until the time of Henry VI) by the King. Early in the fourteenth century the weavers and the goldsmith guilds were formed while mercers, haberdashers, fishmongers and vintners were added during the following one hundred years. The guilds had the power to pass by-laws which governed their respective trades and every person carrying on the trade whether or not a member of the guild was subject to those by-laws so long as they were not inconsistent with the law of the land or public policy. Because of this outward reach of the power in the by-laws, the guilds were required to keep books and those

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disclosure requirements are generally new on the continent; *see* OECD, ADMISSION OF SECURITIES TO PUBLIC SALE AND STOCK EXCHANGES (Paris 1974).

2 F. WEGENAST, THE LAW OF CANADIAN COMPANIES 20 (1931).

3 H. BALLANTINE, CORPORATIONS 36 (1946).

books were opened for inspection by non-members under certain circumstances. This appears to be the earliest form of disclosure required by business corporations.[4]

During the sixteenth century the search for treasures overseas inspired the establishment and incorporation of companies of foreign adventurers which were similar to the guilds except that their members were traders in foreign as opposed to domestic markets. Perhaps the most famous company to be incorporated was the East India Company,[5] chartered by Queen Elizabeth in 1600. Its charter was the first to provide that members could employ their capital in a joint stock if they so desired. When one considers that the fundamental difference in the constitution of modern business corporations as compared with earlier forms of organization is the joint-stock capital concept, the East India Company is justly famous. It is the joint-stock concept which allowed for the rise of public corporations and, eventually, the regulation of securities.

It should not be surmised that a huge number of these joint-stock companies existed in the seventeenth century. Williston asserts that, in 1692, when trading on other than joint stock was prohibited to members of the East India Company, there were only two other joint-stock companies of any importance in England – The Royal African Company and the Hudson's Bay Company. Except for the 200 joint-stock companies formed about the year 1720 to take advantage of the extravagant commercial speculations which culminated in the Bubble Act, there was not an appreciable number of joint-stock companies incorporated in the eighteenth century either. Adam Smith, writing in 1776 said of joint-stock companies:

> "The directors of such companies, however, being the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in private copartnery frequently watch over their own.... They have, accordingly, very seldom succeeded without an exclusive privilege; and frequently have not succeeded with one."[6]

Smith therefore felt such companies were only appropriate in the banking, insurance, canal and waterworks fields, all being businesses where it was unlikely for private copartners to be able to amass sufficient capital.

4 *See* the excellent article by Williston, *History of the Law of Business Corporations Before 1800*, 2 HARV. L. REV. 105, 149 (1888).

5 Formally called the "Company of Merchants of London Trading to the East Indies".

6 A. SMITH, 5 THE WEALTH OF NATIONS, ch. 1, pt. 3 (1776).

Indeed, even in the nineteenth century there were relatively few joint-stock companies formed. As late as 1886 the New York Exchange had less than a hundred companies listed, of which over 80% were in railroads and the four fields mentioned by Smith.[7] With this lack of importance of publicly-traded corporations of a general nature it is perhaps not surprising that corporate disclosure requirements in the statute law were very late in arriving. However, the lack of statutory requirements did not mean that public corporations or even private corporations were not busily keeping records which were open to inspection by the directors or others. As Dubois puts it:

> "Clearly no business, even in the eighteenth century, could be conducted with quite the same indifference to keeping its affairs of record that prevailed at Whitehall."[8]

Accordingly we shall turn our attention to the corporations themselves, for in their charters or by-laws are to be found the earliest disclosure requirements.

The earliest reference we have been able to find to a specific requirement of corporate disclosure comes from the minutes of the Hudson's Bay Company where it was ordered, at a General Court held in 1673:

> "That the names of all the Adventurers in this Company and their several stocks respectively be put in print and a copy thereof sent to each member."[9]

It is interesting to note that this minute goes on to authorize one vote for each £100 of stock held and to permit voting by sending the shareholder's desire to the general court when the shareholder could not be present. In 1679 the Rules and Orders of the Company incorporated these provisions and extended the voting right by absent shareholders so that the shareholder "shall if he please send his suffrages to the Court which shall be received and allowed as if he himself were present". As well, the 1679 Rules and Orders provided that:

> "Every Member having Share or part in any Goods to be sold to the Company, or Ship to be Freighted for the Company's use, shall if he be then present or any way privy to any such Bargain declare his interest to the Company and cause the same to be Recorded or otherwise

7 *See* J. Hurst, The Legitimacy of the Business Corporation in the Law of the United States 1780-1970 at 86 (1970).

8 A. Dubois, The English Business Company After the Bubble Act at xi (1971) (introduction).

9 Minutes of the Hudson's Bay Company 1671-74 (E. Rich ed. 1942). A "general court" is the same thing as a shareholders' meeting.

> on discovery to be made thereof it shall be deemed fraud in the Company and every such member shall forfeit his whole stock or submit to such Mulct as a General Court Shall Impose."[10]

Similar provisions are to be found requiring full disclosure of insider interests in contracts or dealings with the company in other early English corporations, such as the Bank of England.[11] These provisions relating to disclosure of director's interests in contracts were incorporated into the earliest general incorporating statues in England[12] and have been retained in both England and Canada ever since[13] with little modification to the basic concepts.

It also appears that in the early eighteenth century the directors did present reports to the general courts, or annual meetings of joint-stock companies. Misrepresentations made to a general court were considered to be a breach of a director's obligations and penalties ensued, imposed by the company itself. Similarly recorded minutes were kept of general court meetings and deliberate alteration of such recorded minutes was an offence punishable by the general court.[14] Thus we see that some disclosure, at least to existing shareholders entitled to be at the meeting, was a requirement of the corporations themselves.

B. THE EIGHTEENTH CENTURY

The continued existence of joint-stock companies was threatened in the early eighteenth century by the excrescences of the speculative fervour of promoters and stock-jobbers. The Mississippi scheme of John Law in France and the South Sea Company of the Earl of Oxford in England were but the most obvious examples of a general avarice which cast joint-stock companies into a century of disrepute.[15] The English Parliament, panic-stricken by the wild trading in the stock of various joint-stock companies, passed The

10 We wish to record our thanks to Rolph Huband, secretary of the Hudson's Bay Company and Shirlee Anne Smith, the archivist of the Hudson's Bay Archives for their assistance in turning up the disclosure provisions relating to this renowned company.

11 BANK OF ENGLAND, SELECTED TRACTS: 1694-1804 (London 1968). Dubois claims that a similar approach was tried but failed with the East India Company in 1727; A. DUBOIS, *supra* note 8, at 296.

12 *See* An Act for the Registration, Incorporation and Regulation of Joint-Stock Companies, 7 & 8 Vict., c. 110, s. 29 (1844).

13 *See e.g.* Canada Business Corporations Act, s. 115.

14 A. DUBOIS, *supra* note 8, at 295.

15 The most readable account is found in C. MACKAY, EXTRAORDINARY POPULAR DELUSIONS AND THE MADNESS OF CROWDS (12th ed. 1967). *See* for a more complete picture, W. SCOTT, JOINT-STOCK COMPANIES TO 1720 (1909-20).

Bubble Act[16] in 1720 which effectively outlawed joint-stock companies at least where a large stock of freely transferable shares was involved.[17] So effective was that statute, or so in harmony with the beliefs of the business community of the day, that only one case under the act was ever reported in the eighteenth century and that resulted in only a five-pound fine![18]

Incorporation by special act was still permitted although the price was high.[19] Most of these private act corporations were canal companies although a few, such as the British Linen Company, were conceived to be of a manufacturing nature.[20] Usually, in order to deal with the perceived problem of undue stock promotion, the charters contained provisions prohibiting the transfer of stock for a fairly lengthy period of years.[21] Thus the English system at this time, at the legislative level, was based on direct regulation and not on any concept of disclosure. On the other hand, at the enterprise level, unincorporated joint-stock companies formed pursuant to deeds of trust became common.[22] All these companies, like their royal charter cousins, had provisions requiring frequent "general courts".[23] In most deeds of settlement the accounts of the company had to be submitted to the general court and, in a few cases, proprietors had free access to all accounts of the company.[24] During the same period the courts became an accessible forum for the settlement of business corporation disputes. Writs of mandamus to compel disclosure required by the charter or complaints concerning misdeeds of directors were two areas where the courts felt free to intervene.[25] In both these cases full disclosure was an almost absolute defence, with the result that the court, in effect, became an instrument for requiring disclosure.[26]

At this point, it may be worth digressing to consider the position of creditors. While it is generally regarded in basic law school courses as written on a tablet of stone that limited liability

16 6 Geo. 1, c. 18 (1720).

17 *See* the opinions of Sargeant Pengelley quoted in A. Dubois, *supra* note 8, ch. 1.

18 R. v. Cawood, 2 Ld. Raym. 1361, 92 E.R. 386 (K.B. 1723).

19 *See* B. Hunt, The Development of the Business Corporation in England 1800-1867 at 110 (1936).

20 In fact, the British Linen Company soon gave up the linen business and became a bank; W. Lawson, The History of Banking (1850).

21 A. Dubois, *supra* note 8, at 110.

22 A. Machen, Modern Law of Corporations at 7 (1908).

23 Unlike the modern corporation statutes, these joint-stock companies generally required several stockholders' meetings each year.

24 A. Dubois, *supra* note 8, at 302.

25 *Id.* at 123-37.

26 In this period, the courts themselves were seldom resorted to by businessmen but opinions of barristers were frequently sought as to what a court would likely do if

arrived only with the incorporating statutes of the late nineteenth century, this position seems open to grave doubt;[27] it is doubtful if creditors could, in fact, recover from shareholders if the corporation was insolvent. Moreover, the borrowing powers of corporations were often circumscribed by the incorporating legislation.[28] But protection for creditors was generally not afforded in corporate constitutions. Apparently it was assumed by the legislatures that those astute enough to lend as opposed to invest were astute enough to look after themselves.[29] Of course, the courts would permit rescission of a borrowing contract just as they would of a share contract if the contract was based on a misrepresentation.[30]

It should also be mentioned that the remedy of damages for misrepresentation, which was of ancient lineage and not cut down to fraudulent misrepresentations until the infamous case of *Derry v. Peek*,[31] had its effect on truthful disclosure. To sell stock in any enterprise required some representations, even to the most gullible. Accordingly, a custom arose very early of issuing a prospectus to accompany every proposed new share issue. Even on sales in the secondary market, there had to be some information available to attract the interest of investors.[32] Again we see a corporate development, necessitated by business reality, giving rise to disclosure requirements. Court sanctions for fraud and misrepresentations provided a theoretical inducement to accuracy, although they were often ineffective in practice. Direct sanctions by the general court of the corporation were likely more effective. Until the end of the eighteenth century it is fair to say that neither statutes nor self-regulatory organizations played any part in disclosure requirements.

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a matter were brought to its attention. These opinions circulated in business circles and were acted upon.

27 An interesting brief account of the early English cases and commentaries is found in E. Dodd, American Business Corporations Until 1869 at 84 (1954).

28 Perhaps the best known case is Baroness Wenlock v. River Dee, 10 App. Cas. 354 (H.L. 1885).

29 Much later, some incorporating statutes expressly provided for double liability on the part of shareholders. Indeed, such a provision was contained in the Bank Act until 1967.

30 *See* Colt v. Woolaston, 2 P. Wms. 154, 24 E.R. 679 (Ch. 1723); Green v. Barrett, 1 Sim. 45, 57 E.R. 495 (Ch. 1826). Indeed, a non-disclosure by the promoters where a scheme was impracticable *ab initio* had been held to constitute grounds for rescission of a share contract; *see* E. Manson, Trading Companies (2d ed. 1893). This, in effect, forced at least a minimal disclosure to shareholders. Whether the same standard would be applied to creditors' transactions was doubtful.

31 14 App. Cas. 337 (H.L. 1889).

32 *See* C. Mackay, *supra* note 15.

C. THE NINETEENTH CENTURY

With the nineteenth century came the advent of legislative and self-regulatory disclosure requirements. While stock dealers in London had met informally during the eighteenth century, it was in 1802 that the original Deed of Settlement established the London Stock Exchange as a legal undertaking and in 1812 that the first Rules and Regulations of the Exchange were formally adopted.[33] It is important to note that, in England, self-regulation is older than any general legislation. This may explain why the members of the London Stock Exchange are exempted from broker registration requirements and why virtually no over-the-counter market exists for public securities in the United Kingdom. Disclosures required by the stock exchange are perhaps more important in England than statutory disclosure requirements.

On the other hand, while a brokerage fraternity existed in New York at the end of the eighteenth century, the brokers were in rival camps during the first half of the nineteenth century and the New York Stock Exchange only became united into one body in 1869.[34] We have already noted the factors which resulted in the first general incorporating law, that of New York State in 1811. Similarly in Montréal and Toronto, while the brokers had organized themselves as a group in the 1830s and 1840s respectively, official recognition only took place in Montréal in 1874 and in Toronto in 1878,[35] long after the enactment of the first corporation statutes.

In England, in the early nineteenth century, a host of insurance companies were formed as unincorporated joint-stock companies with transferable shares.[36] Two legal difficulties however led to a desire for legislation clearly legitimating corporations. The first difficulty was that, although the early nineteenth century court cases suggested that the Bubble Act was outmoded[37] (and hence encouraged formation of unincorporated joint-stock companies), there were lingering doubts as to the legality of unincorporated bodies with freely transferable shares.[38] Secondly the courts tended to support unlimited liability for members of deed of

33 D. Spray, The Principal Stock Exchanges of the World 178 (1964).

34 H. Noble, The Stock Exchange: Its Economic Function (1933); B. Shultz, The Securities Market and How It Works (1948).

35 W. Eiteman, Nine Leading Stock Exchanges (1968).

36 B. Hunt, *supra* note 19, ch. II.

37 *See* R. v. Webb, 14 East. 406, 104 E.R. 658 (K.B. 1811); Brown v. Holt, 4 Taunt. 587, 128 E.R. 460 (C.P. 1812).

38 Josephs v. Pebrer, 3 B. & C. 639, 107 E.R. 870 (K.B. 1825).

settlement companies.[39] However the desire for clear legislation was thwarted by economic occurrences. In 1825 a post-war speculative fever was running high in England with promoters launching a host of schemes.[40] All these promotions were accompanied by prospectuses[41] which told prospective investors of the marvellous plans for the enterprise involved. Some 624 Special Act companies and joint-stock companies were floated in the years 1825 and 1826, of which only 127 existed in 1827, after the crash. But the mounting pressure for a simple incorporating statute was only sidetracked, not derailed by these events. Eventually, in 1844, the Joint-Stock Companies Registration Act was passed.

The English Act of 1844[42] was the statutory result of a report prepared under the chairmanship of William Ewart Gladstone who was then president of the Board of Trade. Gladstone was a great believer in disclosure as the way to ensure investor protection.[43] Accordingly, the act required every joint-stock company to file in a central registry the charter and, more importantly, "a copy of every prospectus or circular, handbill or advertisement or other such document at any time addressed to the public, or to the subscribers or others, relative to the formation or modification of such company".[44] The statute also required an annual financial statement to be prepared which was open for inspection by shareholders for fourteen days prior to and thirty days subsequent to the annual meeting.[45] In the absence of contrary provisions in the deed of settlement, a copy of the financial statement and the auditor's report were required to be sent to shareholders.[46] A third disclosure requirement embodied in the act was the filing of a complete shareholders' list as well as a semi-annual report of any changes in the shareholders' list.[47] Not only insider trading, but all trading in shares was therefore a matter of public record.[48] In short, it would be fair to say that the disclosure concept of the 1844 Act was, if anything, wider than the disclosure concepts now current. But there was much less specificity; for example, the contents to be contained in the prospectus were not set out in the statute at all. This lack was relatively quickly supplied by the

39 B. Hunt, *supra* note 19, ch. II.
40 *Id.*
41 *Id.*
42 7 & 8 Vict., c. 110 (1884).
43 His most famous quote in this regard is "publicity is all that is necessary. Show up the roguery and it is harmless"; *see* 75 H. C. Deb. (Eng.) 277 (1844).
44 7 & 8 Vict., c. 119, s. 4(8) (1844).
45 *Id.* s. 37.
46 *Id.* s. 42.
47 *Id.* s. 11.
48 *Id.* s. 18 provided for inspection by anyone of all the records required to be filed with the registrar.

courts. In the leading case of *New Brunswick and Canada Railway and Land Company v. Muggeridge*, Kindersley V.C. said:

> "[T]hat those who issue a prospectus setting forth great advantages to accrue to those who will take shares in the undertaking, and inviting them to take shares on the faith of the representations contained, are bound to state everything with strict and scrupulous accuracy; and not only to abstain from stating as facts that which is not so, but to omit from stating no one fact within their knowledge, the existence of which might in any way affect the nature or extent or quality of the privileges and advantages which the prospectus holds out as an inducement to take shares."[49]

Later the courts retreated from the proposition that non-disclosure was as objectionable as false disclosure,[50] a retrograde step which probably lies behind the detailed list of disclosure requirements in many modern statutes.

The English provisions are in marked contrast to the early New York statute of 1811,[51] where there was much less emphasis on disclosure. The real difference lay in the amount of material required to be filed in the central registry for, as we have seen, the companies themselves produced the type of information which Gladstone's Act required to be filed. The New York statute required very little to be filed, in the same way as the letters patent jurisdictions in Canada required very little to be filed with the provincial or federal incorporating authorities. There were requirements in the New York statute for publication in the local newspapers of the time and place of the annual meetings. Outside of this provision, there were no statutory disclosure requirements except those required on the initial filing of the incorporating documents.

The lack of specificity in prospectus requirements and the changing view of the English courts to non-disclosure, prompted statements in prospectuses to become less expositive and more fanciful. Thus a finance company in 1863 announced that its objects were "in a word, to undertake all such operations as an intelligent and experienced capitalist might effect on his own account with a capital of millions".[52] In addition, limited liability,

49 1 Dr. & Sm. 363, 62 E.R. 418 (Ch. 1860); *see also* Pulsford v. Richards, 17 Beav. 87, 51 E.R. 965 (C.A. 1853).

50 Peek v. Gurney, L.R. 6 H.L. 377 (1873); *see generally* J. Stevens, Joint Stock Companies, ch. 2 (1881); F. Wegenast, *supra* note 2, at xxvi.

51 N.Y. Session Papers, c. 67 (1811).

52 *Cited in* B. Hunt, *supra* note 19.

which had become statutory in 1855,[53] encouraged, or was subsequently thought to have encouraged, more reckless speculation. The result was the familiar market boom followed by the inevitable crash which occurred in 1866. In the usual way, loud cries again arose to abolish companies with limited liability; a Parliamentary Committee on Limited Liability Acts was established. As a result came the Act of 1867[54] which, for the first time included a statutory definition of the contents of a prospectus.[55]

In the United States, the absence of a uniform federal system[56] and the differing economic realities in the various states made for a patchwork that ensured little or no disclosure requirements through corporation law, if the promoters were prepared to look for a friendly jurisdiction. The laws generally did not require a continuing flow of corporate information to a public registry. The nearest approach to such a development was through informal pressures of investment bankers and the New York Stock Exchange.[57] Even this pressure could not be expected to be very heavy for in late 1886 there were only ninety issues listed on the exchange, of which sixty were by railroads. The "public" investor was still likely to be a businessman who demanded to see records before he would put any money into a venture.[58] It was not until after World War I that the roster of listed stocks and bonds became widely expanded.[59] But as early as 1866 the New York Stock Exchange required some reports from companies desiring to list, and by 1895 this had developed into a strong suggestion for periodic reporting. However it was only in 1909 that the exchange required listed companies to distribute annual earnings reports and balance sheets to their stockholders. [60]

D. EARLY CANADIAN REQUIREMENTS

The early Canadian experience borrowed much from the practice of the English in setting up joint-stock companies, although

53 18 & 19 Vict., c. 133 (1855). L. GOWER, chs. 2, 3, contains an excellent description of the development of English company law. The reader is referred *id.* for more detail on the Companies Clauses Consolidation Act of 1845, 8 & 9 Vict., c. 16 (1845) which was a complementary statute dealing with corporations which still had to be chartered by private act.

54 30 & 31 Vict., c. 131 (1867).

55 *See* B. HUNT, *supra* note 19.

56 *See* H. CHERRINGTON, THE INVESTOR AND THE SECURITIES ACT, ch. 2 (1973).

57 A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 319 (1932); B. SHULTZ, *supra* note 34, ch. 1.

58 J. HURST, *supra* note 7, at 86.

59 By 1930, there were 2,407 issues by U.S. companies listed on the NYSE; *see* J. MEEKER, THE WORK OF THE STOCK EXCHANGE 538 (1930).

60 J. HURST, *supra* note 7, at 91.

incorporation statutes, at least in the east, initially seemed to borrow more from the United States.[61] For example, the Canada Life Assurance Company was originally established by a Deed of Settlement, dated January 1, 1848.[62] The deed provided an annual meeting at which an annual "statement of the affairs of The Company shall be laid before the Stockholders". Notice of meetings was required to be given by mail to each shareholder at least twenty days before the meeting and, as well, advertised in the local newspaper. The notice was to "distinctly specify the particular business or motion to be brought before the meeting". There is nothing in the document suggesting that shares were to be offered to the public, in fact the detailed transfer and registration of members' provisions suggest that a public subscription was not contemplated. The deed clearly contemplated an application to Parliament for a special act which in fact was granted in April of 1849.

The first general incorporating statute for usual commercial companies in Canada was the 1850 Act of the United Provinces. This act required annual reports to be published in the local newspaper and required the company to keep a list of shareholders which was open to both creditors and shareholders. It did not however provide for the filing of extensive documentation in a central register like the English Act of 1844.[63] It was not until the twentieth century that the prospectus concepts were really introduced into Canadian law. In the federal act of 1917 there was still no requirement for a prospectus although if a prospectus was not used, a statement in lieu of a prospectus had to be filed.[64] On the other hand the provincial statutes were clearly ahead of the federal statutes in this regard. The Ontario act of 1907 required that a prospectus, whose contents were detailed in the legislation, be filed and delivered to each prospective purchaser.[65]

E. THE FIRST HALF OF THE TWENTIETH CENTURY

Until recently in England, disclosure was contained in the

61 *See* F. WEGENAST, *supra* note 2, at 20; *but see* LaBrie & Palmer, *The Pre-Confederation History of Corporations in Canada*, in 1 STUDIES IN CANADIAN COMPANY LAW 59 (J. Ziegel ed. 1967). A more recent interesting article on early Ontario corporations is Risk, *The Nineteenth Century Foundations of the Business Corporation in Ontario*, 23 U. TORONTO L. J. 270 (1973).

62 Apparently, there was an earlier agreement dated August 21, 1847 but the first formal Deed of Settlement was dated January 1, 1848. We are indebted to the officers of Canada Life for their assistance in providing us with a photocopy of this early deed.

63 *See* LaBrie & Palmer, *supra* note 61, at 57.

64 F. WEGENAST, *supra* note 2, at 690.

65 7 Edw. 7, c. 34, ss. 97, 99 (1907).

Companies Act although the London Stock Exchange, with its stringent system of vetting and exercising control over new issues, was probably more important than the applicable British statutory provisions.[66] Very recently there has been some agitation to change the system as more and more writers come to doubt the efficacy of a system based on self-regulation and the "reputation" of issuing houses.[67] In any event the English system, as a system, is not suitable to conditions in Canada. In England there is but one incorporating authority, one stock exchange and one financial centre while in Canada there are eleven jurisdictions of incorporation, several stock exchanges, an over-the-counter market and at least three financial centres. That is not to say that certain English requirements should not be integrated into a Canadian regime. Clearly in some areas, particularly in takeover bids, the English have led the way. But for the most part, the United States is a more fertile ground for useful historical research.

In the United States, the permissiveness of the state incorporating laws[68] led first to state regulatory laws and later to the federal securities laws. At the federal level, in the early decades of the twentieth century, the Federal Trade Commission was active not only in blocking the sale of some securities but also in sending promoters of fraud to jail. Yet the constitutional basis of its interference as well as the practical difficulties made this agency ineffective on any broad basis. Several bills were introduced into Congress but none passed through both Houses until the Securities Act of 1933.[69] At the state level however, a more direct form of regulation was imposed starting with the Kansas Statute, in 1911.[70] These state laws are generically known as "blue sky" laws[71] although they appear to fall into at least two different

66 *See* H. CHERRINGTON, *supra* note 56, at 91, where he points out some of the ways ingenious English lawyers invented to get around the statutory provisions.

67 *See* L. GOWER at 310; and *see* the excellent article by Emerson, *An Integrated Disclosure System for Ontario Securities Legislation*, in 2 STUDIES IN CANADIAN COMPANY LAW 400 (J. Ziegel ed. 1972) which is a revised version of an article which first appeared in 10 OSGOODE HALL L. J. 1 (1972).

68 *See* W. FLETCHER, 1 CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS at 527 (M. Wolfe ed. 1974).

69 For a brief discussion of the role of the FTC and of various congressional attempts, *see* H. CHERRINGTON, *supra* note 56, ch. 2; 1 L. Loss at 116.

70 Direct regulation of stock jobbers had existed in England since 1285; *see* 1 L. Loss, ch. 1. There had also been disclosure-type laws at the state level, Nevada's 1909 law being the earliest.

71 The term "blue sky" is said to come from various sources but the most often cited is Hall v. Geiger Jones Co., 242 U.S. 539, 550 (1917), the earliest state securities case to come before the U.S. Supreme Court. The idea of "blue sky" is the same as "moose pasture"- *i.e.* that promoters of a given scheme have nothing of value to promote. Mulvey refers to a report by the Kansas State Banking Commission, published

categories.[72] One type is direct regulation: no securities can be sold without the approval of the state "blue sky" commission, although of course there are many exceptions for securities such as government bonds.[73] The other type of "blue sky" law does not interfere with a flotation of any security unless it appears that fraud has been or is about to be committed.[74] The Kansas Statute was of the direct regulation variety and was quickly copied in many states and in four Canadian provinces.[75] The fraud variety was eventually followed in Canada as well when Ontario enacted the Security Frauds Prevention Act in 1928, which act was said to combine "the desirable features of the New York Martin Act and the 'blue sky' laws of forty other states".[76] The Ontario Act became the basis for statutes in all the other provinces[77] and was the basic securities registration statute until 1945.

The 1928 statute is important as it combined two distinct features from other legislation and omitted our major concern, namely, corporate disclosure, which was left to the Companies Information Act.[78] The Securities Fraud Prevention Act listed certain practices which were declared to be frauds and attached to these practices criminal penalties.[79] In addition the statute provided for registration of brokers but it did so by prohibiting all "trading" without registration, defining "trading" very broadly and then setting out a series of exemptions.[80] The prospectus provisions contained in the Companies Information Act were not integrated into the Securities Act (as it then became) until 1945.[81]

So matters stood in 1933 when the really significant develop-

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September 1, 1912 which clearly uses "blue sky" as though it were already a familiar phrase; *see* Mulvey, *Blue Sky Law*, 36 CAN. L. J. 37 (1916).

72 The categories were set out initially by F. ASHBY, THE ECONOMIC EFFECT OF BLUE SKY LAWS (1926). Loss further divides the registration category into regulation of salesmen and registration of securities; *see* 1 L. Loss at 33.

73 California is the usual example cited of this type of direct regulation.

74 The New York Martin Act of 1921 is the usual example; *see* H. CHERRINGTON, *supra* note 56, at 51.

75 Manitoba, Saskatchewan, Alberta and New Brunswick. The Manitoba Sale of Shares Act of 1912, 2 Geo. 5, c. 75 was almost a verbatim copy of the Kansas Act; *see* Mulvey, *supra* note 71; and *see* J. WILLIAMSON at 12.

76 J. WILLIAMSON at 21.

77 The reason for the adoption was likely the decision of the Privy Council in Attorney-General for Manitoba v. Attorney-General for Canada, [1929] A.C. 260 which declared the Manitoba Statute *ultra vires*.

78 S.O. 1928, c. 33. The act had a "blue sky"-type regulation whereby the prospectus could be rejected by the administrator.

79 No civil penalties were attached and courts in Canada are extremely reluctant to read in civil penalties in the securities area; *see* Ames v. Investo-Plan Ltd., 35 D.L.R. (3d) 613 (B.C.C.A. 1973), *noted in* Beck, Comment, 32 CAN. B. REV. 589 (1974).

80 This pattern of dealer registration has been carried forward into the current provincial statutes, virtually unamended.

81 Securities Act, S.O. 1945, c. 22.

ments started to take place in the United States at the federal level. The conflicting philosophies between a Martin Act-type fraud statute, a "blue sky"-type registration system and a Gladstonian disclosure system,[82] were finally resolved in favour of a disclosure system. In brief the Securities Act of 1933 prohibits a company from offering securities to the public unless a registration statement has been filed with the Securities and Exchange Commission (SEC).[83] No sales can take place until twenty days after filing with the SEC and a prospectus, which forms part of the registration statement, must be sent to the prospective purchaser at or before the time of sale. The two major advances from the Gladstone theory were the twenty-day waiting period and the fact that the SEC checked the registration statement for misstatements and omissions. The high quality of the administrative effort by the SEC is what permits investors even today to rely on the prospectus.[84] But the 1933 act is not a continuing disclosure act, nor does it deal with secondary trades except out of a control block. In theory at least, the SEC has no authority to approve any security or to pass on its effectiveness.[85] There are exemptions for certain types of securities and certain transactions from the registration provisions which will be discussed in more detail later. A separate provision prohibits generally fraudulent or manipulative conduct.

The 1933 act was quickly followed by the Securities Exchange Act of 1934 which deals with the secondary markets and the registration of brokers. Essentially that statute required every corporation that listed securities on an exchange to file with the SEC both registration statements and periodic reports. In addition, where proxies were solicited, it required that the solicitation be accompanied by a proxy statement[86] and that periodic reports be made to shareholders. Insider trading reports and insider trading liability were also covered. In quick succession a series of

82 The Gladstone of the United States in this area was Louis D. Brandeis who wrote in 1914, "Sunlight is said to be the best of disinfectants; electric light the most efficient policeman"; L. BRANDEIS, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT at 62 (1914 R. Abrams ed. 1967). William O. Douglas, on the other hand would have opted for more direct regulation; *see* Douglas, *Directors Who Do Not Direct*, 47 HARV. L. REV. 1305 (1934). *See generally* 1 L. LOSS at 111; LOSS suggests part of the 1933 act is the fraud theory of the Martin Act.

83 Knauss, *A Reappraisal of the Role of Disclosure*, 62 MICH. L. REV. 614 (1964). Note, in the United States the securities are registered. This has not been the system in the Canadian provinces where only the prospectus is filed.

84 *Id.*

85 This gave rise to the legend on the prospectus to the effect that the issue was not to be construed as approved by the SEC. This same legend has been adopted in provincial legislation in Canada although the basic reason for its existence in the United States appears to be lacking in Canada.

86 Which statement has been referred to by LOSS, amongst others, as the most important document in the disclosure arsenal.

other statutes were put under SEC jurisdiction – The Public Utility Holding Company Act of 1935 (a regulatory statute in a particular industry which had been found to have more than its share of corrupt practices), chapter X of The Bankruptcy Act (under which the SEC may, at the request of the court, advise on a plan of reorganization), the Trust Indenture Act of 1939 (which relates to the terms of trust indentures and promotes the independence of trustees), the Investment Company Act of 1940 (which allows more direct regulation over industries covered thereby, particularly mutual funds) and the Investment Advisers Act of 1940 (which requires anyone giving investment advice to register with the SEC). This panoply of statutes with various extensions[87] forms the basis of securities regulation at the federal level in the United States. Slowly but surely the provinces of Canada have come closer to copying the provisions of these various statutes.

F. THE CANADIAN EXPERIENCE FROM 1933 TO 1967

Shortly after the introduction of federal securities legislation in the United States, the call was revived[88] for federal securities legislation in Canada. In 1935 the Royal Commission on Price Spreads strongly recommended the formation of an "Investment or Securities Board" which would have a "blue sky" function at least with respect to Dominion companies. In its report, the Royal Commission stated:

> "We are not so optimistic as to believe that any legislation, however wisely conceived and effectively administered, will prevent all foolish investments or all unsound company promotion. We have, indeed, no right even if we had the desire, to take away from the citizen his inalienable right to make a fool of himself. We do, however, feel that we have the right to attempt to prevent others making a fool of the citizen. We would emphasize also, first, that permission for a group of persons to be incorporated into a company should be viewed as a valuable concession granted by the state, especially in relation to the convenience of a general restriction of personal liability, and, second, that such a concession involves corresponding obligations and responsibilities. Not the least of these obligations is to ensure that there shall be full and accurate information as to all the facts concerning every

87 Such as the Williams Act for takeover bids; *see* Pub. L. No. 90-439, 82 Stat. 454 (1968) *amended by* Pub. L. No. 91-567, 84 Stat. 1497 (1970) *amending* Securities Exchange Act of 1934, ss. 13-14.

88 It had sounded before in 1916; *see* Mulvey, *supra* note 71.

> company that seeks incorporation or financial support from the public after such incorporation."[89]

The federal government, however, opted to follow along in the tradition of the English acts thereby including in federal legislation no provisions for checking the material required to be filed in Ottawa even by federal companies.[90] Again the initiative was left to the provinces which proceeded on a province-by-province basis with Nova Scotia leading the way in 1936. Eventually the Ontario Act of 1945 was enacted which was the real beginning of a comprehensive securities regulation regime in Canada. While the legislation was studded with loopholes, some of gargantuan proportions,[91] the essential features which characterized provincial legislation until at least 1967 were presented. Disclosure requirements were refined and expanded, the Ontario Securities Commission (OSC), was given an important role in checking the prospectus[92] and requirements for dissemination of the prospectus to prospective investors were clarified.[93] But two important provisions of the United States Securities Act of 1933 were not introduced, namely the twenty-day waiting period and the concept of delivery of the prospectus as the first document to reach the prospective investor. Nor were the other seven statutes administered by the SEC integrated into the provincial securities legislation. This was particularly important with respect to periodic reporting, insider trading reporting and timely disclosure. The 1945 statute was aimed at new issues only, including within that phrase distributions by persons in a control position. In addition, the melding of the new issue requirements with the broker registration requirements of the 1928 statute gave the draftsman an opportunity to try to utilize or at least to cross refer to the same exempting requirements for each. This produced an unsatisfactory set of exemptions, which has been a feature of Canadian securities legislation ever since.

89 REPORT OF THE ROYAL COMMISSION ON PRICE SPREADS 38-39 (1935).

90 *See* J. WILLIAMSON at 171. In fact, the federal statute of 1934 did not even adopt the extension in the English Act of 1928 to cover disclosure requirements on new issues by firm commitment underwriters as opposed to underwriters acting merely as agent for the issuer itself. This was inserted in the 1935 amendments as was one other important piece of new disclosure - an annual report by directors of their trading in securities. The provision, however, was ineffective in practice as the shareholder had to ask for the record of the director's trading and seldom, if ever, did so.

91 The phrase is taken from Baillie, *The Protection of the Investor in Ontario*, 8 CAN. PUB. ADMIN. 172, 180 (1965).

92 The legislature was told by the responsible Minister that the legislation was of a disclosure, not of a regulatory nature, but that is open to considerable doubt; *see* J. WILLIAMSON at 32; Baillie, *supra* note 91, at 175.

93 *See* J. WILLIAMSON at 30.

While the 1945 statute was the basis of Canadian legislation until 1967, it is not necessary to examine its workings in detail, as this topic has been thoroughly treated in the works of Williamson and Baillie.[94] In the early 1960s, a series of important reports, the necessary antecedents of legislative change in Canada, emerged. These reports resulted in the statutes which we now have in Canada, although a major effort at revision has again been going on almost constantly since 1970. The first report was the *Porter Report*[95] which emanated from a federal Royal Commission and therefore was not expected to concern itself with securities regulation. Its rather extensive recommendations in the securities area have been ignored by most subsequent writers,[96] perhaps because his report was directed to the federal government. But Porter examined the securities industry in more depth, not only from a legislative perspective, but also from a practical administrative point of view, than any government report has either before or since. It noted that the provincial administrators were trying to promote uniformity and, to this end, were meeting ever more frequently, a trend which has continued up to the present. Its reaction to this was to strongly recommend a federal agency as the problem was obviously a national one. This is more remarkable when one remembers that Porter himself was a provincial cabinet minister and, at one time, the minister reponsible for securities legislation in Ontario. With respect to disclosure, the report said:

> "Standards of disclosure in this country are still generally inadequate. Even in the case of prospectus requirements, where the greatest improvements have taken place, more information should be required on the salaries of executives and material contracts affecting the business, on the names of beneficial owners of 10% or more of the voting stock and how much they own, and on details of executive stock options, bonuses and pension plans. Most important, the financial statements accompanying the prospectus should be in the form normally required by good auditing standards and should contain sales figures. Canadian prospectuses would also be more comprehensible if they were prepared in the narrative style of United States prospectuses rather than in a legal-

94 It is one of the sad features of Canadian legal writing that there is never enough of it. J. Williamson appeared in 1960, Baillie, *supra* note 91, in 1965, and J. Williamson, Supp. (which, like the 1969 Supplement to L. Loss, was as large as the first treatise) in 1966. The new legislation appeared in 1967 since which time there have been only a few good articles and no complete review.

95 The chairman was the late Chief Justice of Ontario, Dana Porter.

96 Baillie, *supra* note 91, does mention the Porter Report at some length.

istic manner in which the statutory information is presented point by point in a way which often deters the readers.

"The enforcement of 'full, true and plain' disclosure ends in Canada with the securities acts...the provisions of the companies acts are neither so exacting nor so well enforced. In our view, companies should be required under these acts to provide annually prompt and comprehensive information containing sales figures, comparative data going back several years, and information about long-term lease payments and contingent liabilities such as obligations to unfunded pension plans. Accounts of subsidiaries should be consolidated, and wherever there are securities of a subsidiary in the hands of the public, a balance sheet and profit and loss statement for the subsidiary should be published. Moreover, corporate financial data should be available, not necessarily in audited form, more frequently than once a year. While we are not prepared to recommend the legal requirement of quarterly reports at this time, such a step may well be necessary to arrive at standards of disclosure already practised in the United States and essential to the development of an informed investing public. These are matters in which the proposed federal agency could play an important and constructive role.

"We believe that more stringent disclosure laws are essential if the stock exchanges are to be successful in their campaign to achieve more extensive and frequent corporate reporting in Canada. While the situation is improving, the attitude of too many corporations is that the intelligent and informed investor is a nuisance rather than a partner in the enterprise and that, if necessary, listing on the stock exchanges could be sacrificed rather than provide the full disclosure found in the United States....Quite independently of stricter company laws, we think the stock exchanges should be more insistent on requiring high standards – we cannot believe that all companies whose disclosure practices are inadequate would be prepared calmly to contemplate delisting of their shares. In this connection, the Toronto Stock Exchange's provisions relating to the disclosure of material changes in a company's affairs could usefully be broadened to require more companies to inform their shareholders of such changes....

"The Canadian shareholder is relatively exposed to insid-

er abuse. We recommend therefore the adoption of disclosure requirements similar to those now in effect in the United States but extended to all public companies. These requirements might be included in the securities acts and administered by the securities commissions, although the stock exchanges should take an independent lead in this matter. A similar tightening up in the enforcement of stock exchange and securities act provisions with respect to the dissemination of insider tips and rumours could well be carried out. Finally, the law should provide for fuller disclosure of how funds raised for natural resource exploration and development have actually been spent and should provide for express shareholder approval of all contracts with insiders or their agents.

"Another and closely related problem on which we believe some legislation is necessary is that of take over bids. New management or amalgamation can play an important role in improving the efficiency of Canadian corporations, but if brought about by take overs there can be undesirable side effects if shareholders are not given the time or information necessary to judge the proposal on its merits....

"Another area where Canadian corporations, including mutualized insurance companies, are not required to fulfil their normal obligations to shareholders is in the solicitation of proxies. It was pointed out to us that notification of a shareholders' meeting in Canada all too often is confined to a brief and very general agenda and a request for a proxy signed in favour of the management. Generally, no provision is made to allow the shareholder to direct the voting of his shares, either for directors or on particular issues; no space is provided for him to appoint any other person as his proxy, and no information is provided to enable him to form judgments about the matters on the agenda. As a consequence, investors are discouraged from taking a responsible and intelligent interest in their company....

"We strongly urge, therefore, that both the stock exchanges and the securities commissions require that proxy material be expanded...."[96a]

This extensive quotation, we believe, puts into perspective as of 1964 the major lacks in the Canadian disclosure system. Once again the federal government opted for inaction.

96a Porter Report at 349-52.

More often referred to but less dramatic in its phraseology was the *Kimber Report* of 1965,[97] which ultimately resulted in a new wave of provincial securities acts which have formed the basis for Canadian securities regulation for the past eight years. The report recommended new provisions with respect to insider trading, financial disclosure, revised prospectus disclosure, periodic disclosure through mandatory annual reports and "information circulars"[98] and a suggested new disclosure on takeover bids.[99] One of the most important changes suggested was the introduction of the "waiting period" which had been such an important concept in the United States.[100]

Meanwhile, the great Texas Gulf discovery of a rich copper-zinc-silver property near Timmins, Ontario, announced in June 1964, sparked a speculative mining boom which in turn gave rise to other inquiries, the most important of which in Canada were the *Timmins Area Inquiry* of the Ontario Securities Commission[101] and the *Windfall Report*.[102] These reports focused on the speculative mines, their financing and regulatory control as opposed to the more tranquil world of industrial companies.[103] Mr. Justice Kelly did not criticize the recommendations of the *Kimber Report* but he did feel that the changes suggested "would seem to be premature until the scope of the job required to be done by the Securities Commission has been determined and the extent of the necessary reorganization measured against that job".[104] Kelly, quoting the sentiments of Justice William O. Douglas, also called for regulation of the secondary markets, an area largely ignored in the *Kimber Report*.[105] In short, he saw a vastly expanded role for

97 The chairman was J.R. Kimber, then chairman of the Ontario Securities Commission, later president of the Toronto Stock Exchange.

98 Although the SEC legislation was the basis for these proposals, the terminology "proxy statement" was changed to "information circular".

99 The Ontario takeover bid legislation predated the Williams Act in the United States. It will be recalled that the PORTER REPORT had called for disclosure in this area. *See also* Baillie, *supra* note 91, at 207.

100 It still remains only a paper concept in Canada because the preliminary prospectus is not widely distributed in many issues. Criticisms of the Kimber proposals are found in Baillie, *supra* note 91.

101 SPECIAL INQUIRY SECTION OF THE ONTARIO SECURITIES COMMISSION, TIMMINS AREA INQUIRY (1967).

102 The chairman was Mr. Justice Arthur Kelly of the Ontario Court of Appeal.

103 It will be recalled that "trading companies" were the speculative problems of the eighteenth century. Their counterpart in the twentieth century in Canada has been "penny" mining companies whose stock fluctuations have fascinated those with a predilection for gambling; *see* WINDFALL REPORT at 95.

104 WINDFALL REPORT at 97; *see also* KIMBER REPORT ¶ 8.07, to the same effect. Mr. Justice Kelly also called for "the establishment of a body with national jurisdiction, to regulate the procedure of all exchanges in Canada"; WINDFALL REPORT at 102.

105 The KIMBER REPORT had recommended that primary distributions through the Toronto Stock Exchange be discontinued; *see id.* at 63. Kimber pointed out that the

the Securities Commission, a role with which Mr. Kimber, as its chairman, no doubt agreed with but felt more diffident in expressing.[106]

Both the *Windfall Report* and the *Timmins Area Inquiry* were directed largely, although not exclusively, to practices prevalent at the time on the Toronto Stock Exchange. It will be recalled that both in the United States and in England, disclosure requirements of the stock exchanges had filled legislative disclosure vacuums from time to time and indeed the London Stock Exchange is still considered to have the major disclosure requirements for public companies in the United Kingdom. In Canada, the stock exchanges were formally structured after statutory disclosure requirements and it is likely fair to say that, at least until recently, they had little impact on disclosure by public companies. This is not to denigrate the role of the exchanges. When the various states in the United States were concerned about Canadian brokers pushing unregistered stock in their states, effective legislative action was not forthcoming in Canada[107] and it was the stock exchanges together with the securities commissions that closed down the bucket shops.[108] On the other hand, the unrestricted use of the stock exchanges to effect primary distributions of mining securities had been widely criticized before the Act of 1967.[109]

In the disclosure area, the Toronto Stock Exchange, followed closely by the Montreal and Canadian exchanges, did insist upon filing statements in 1958 which required any listed company to advise the exchange and to secure its permission before any major transaction of any kind was entered into. In addition, the exchanges imposed annual reporting requirements to shareholders which, in general, were more onerous than those required by the companies acts. Perhaps most significant, however, were and are the requirements of timely disclosure, pursuant to which every listed company agrees to notify the exchange of any material change in its affairs.[110] But the consensus before 1965 at least appeared to be that, if a prospectus was filed with the Ontario Securities Commission, that body was far more searching in its examination of the company than was the Toronto Stock Ex-

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practice had ceased on the London Stock Exchange after a court case in 1892 and had ceased on the exchanges in the United States in the early 1930s as a result of the 1929 crash.

106 Kimber Report at 66-68.

107 *See* J. Williamson, ch. XIII.

108 Porter Report at 346-47.

109 *See* Baillie, *supra* note 91, at 357; Porter Report at 334; Windfall Report at 113.

110 A good summary of the requirements as at 1960 can be found in J. Williamson at 270. A much more extensive analysis is given by Baillie, *supra* note 91, at 335.

change.[111] Nor was there any system of adequate dissemination of the information disclosed to the exchanges, thus rendering the disclosure of little value to the investor.[112] Further complicating the issue was the "exempt list" which specified certain companies to which the more rigorous disclosure standards did not apply. Thus the exchange disclosure system, which was the only effective disclosure system relating to information of importance to secondary trading prior to 1967 was incomplete at best.[113]

Since 1967 there have been several important reports, statutory amendments and changes required by the stock exchanges. It is unclear at the time of writing exactly what current securities legislation will look like by the end of 1977 at the provincial level in Canada, in view of proposed statutory changes in Ontario. An exposition of the position since 1967 will be deferred until we consider the purposes of disclosure legislation and its relationship to "blue sky" regulation. For it is against these purposes that the present system and the proposed provincial system must be judged.

Chapter III
Reasons for Disclosure Requirements

When one looks at the alternative forms of securities regulation, we have noted above that historically there have been at least three types of regulation suggested; direct regulation through registration, whereby all securities[114] to be sold to the public must be first registered with and approved by a commission; prevention of fraud statutes whereby possible frauds are investigated by and prosecuted by a commission; and disclosure of information statutes which ensure that information about the issuer and its securities is publicly available. In England, the United States and Canada, where all three systems have been tried, it is safe to say that disclosure has formed the keystone of the legislative schemes in the past few decades.[115] Over the last ten years the disclosure

111 *Id.* at 343.

112 *Id.* at 344.

113 *Id.* at 352.

114 This may include registration of the vendors or brokers as well.

115 *See* SECURITIES AND EXCHANGE COMMISSION, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS (1963); contrast the European system where disclosure concepts are only now gaining ground; *see* Beaman, *supra* note 1. For recent U.K. developments *see* REPORT OF A WORKING GROUP OF THE LABOUR PARTY INDUSTRIAL POLICY SUBCOMMITTEE, GREEN PAPER: THE COMMUNITY AND THE COMPANY, REFORM OF COMPANY LAW (London 1974); Council of the Stock Exchange, Comments on the Green Paper on the Reform of Company Law (London, July 1974); and *see* Knauss, *Securities Regulation in the United Kingdom: A Comparison with the United States Practice*, [1971] VAND. J. TRANSNAT'L L. 49.

requirements have expanded considerably in all three countries, but particularly in the United States.[116] Perhaps as a result of this expansion, the dialogue has intensified between those who support a full disclosure regime and those who decry, as not only useless but also economically wasteful, the current disclosure requirements let alone any proposed extensions thereto.[117] It may well be that disclosure is a form of regulation which is an alternative to what might otherwise be a perceived necessity for more direct regulation of security issues by business enterprises, just as a strong competition policy may be an alternative to direct government regulation in other areas.[118] If so, then even if its benefits be difficult to quantify, abandonment of the march towards a full disclosure regime may portend what to many would be a more distasteful and certainly more costly form of regulation, namely, direct regulation of transactions in the securities markets.

Even more difficult to grapple with is the emergence of disclosure requirements whose relevance to securities regulation in the sense of investor protection or as useful information to the sophisticated investor[119] is nowhere apparent. In introducing proposed new legislation in Australia, the Attorney-General called for disclosure of "arrangements made by the corporation for protecting the safety and health of its employees and of the public and for protecting the environment; and arrangements made by the corporation for the protection of its consumers".[120] In a similar vein is the current pressure in the United States to disclose bribes paid to foreign officials and political contributions.[121] Indeed the limits

116 *See* Garrett, *The Role of Financial Public Relations*, PUB. REL. J., October 1974, at 14.

117 The controversy in a nutshell, including the thrust, parry and counter-parry, is admirably set out in three short articles: Benston, *Evaluation of the Securities Exchange Act of 1934*, FINANCIAL EXECUTIVE, May 1974, at 28; Sommer, *The Other Side*, FINANCIAL EXECUTIVE, May 1974, at 36; Benston, *"Comments" on the Other Side*, FINANCIAL EXECUTIVE, May 1974, at 40. Benston's basic paper was originally published as *Required Disclosure and the Stock Market: An Evaluation of the Securities Act of 1934*, 63 AM. ECON. REV. 132 (1973). The original paper is difficult to understand for anyone not attuned to mathematical economics.

118 Competition policy has also provoked a heated debate in the United States for decades and, more recently, in Canada. The classic exposition of the futility of anti-trust laws is probably J. SCHUMPETER, CAPITALISM, SOCIALISM AND DEMOCRACY (1942); J. GALBRAITH, THE NEW INDUSTRIAL STATE (1967) is a more popular version of essentially similar arguments.

119 A very good article on this distinction is Anderson, *The Disclosure Process in Federal Securities Regulation: A Brief Review*, 25 HASTINGS L. REV. 311 (1974).

120 Speech by Senator L.K. Murphy, Attorney-General of Australia, on the Corporations and Securities Industry Bill, 1974, Parl. Deb. (Aust.), December 5, 1974 (reprint accompanying bill).

121 *See, Telling All*, The Wall Street Journal, May 15, 1975. A. Sommer, a former SEC commissioner, is quoted as saying that some members of the SEC ignore the distinction between disclosure as a means for informing investors and disclosure as

of required and "discretionary" disclosure are constantly expanding.[122] New concepts of social responsibility together with a felt need for the public to influence corporate decision-making are among other factors which may be identified as partially responsible for the continuing clamour for ever more disclosure.[123] Even a member of the SEC has vindicated disclosure requirements on the basis of benefit "to the economy at large" as a distinct head of justification alongside benefit "to the investing public".[124]

It is with a recognition of the current controversy over the extent of useful disclosure coupled with a belief that the society would prefer to avoid more costly direct regulation of business enterprises if indirect techniques, such as disclosure, prove sufficiently efficacious, that we have reexamined the purposes of disclosure legislation. In so doing we have considered what we see as two separate concepts – disclosure necessary for securities regulation itself in the sense of investor protection and the extension of such disclosure requirements for purposes other than securities regulation. It is not necessary for us to agree with all such extensions to admit that such extensions presently exist and that further extensions are currently being advocated. Where such extensions are logically and pragmatically attainable and where the extensions do not dwarf the original purpose of investor protection, we would acquiesce in their inclusion in statutes primarily aimed at the regulation of transactions in securities.

Put another way, a society characterized by large financial institutions, large corporations, large labour organizations and large governments leads naturally in a democracy to demands for accountability. Large size, by itself, while necessary to support an advanced society, is believed by many to be justified only if some system exists to ensure that the controllers of large institutions do not misuse the powers and wealth which arise as a result of their positions.[125] to the detriment of the public or of an identifiable part of society. Accountability presupposes disclosure.[126] It is to be expected therefore that rules will evolve in the society to ensure disclosure by any institution where it is perceived that some

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a means of altering conduct in Guzzardi, *An Unscandalized View of Those "Bribes" Abroad*, FORTUNE, July 1976, at 119, 121.

122 Weiss, *The Limits of Disclosure*, 7 REV. SEC. REG. 943 (April 10, 1974); Gillis, *Corporate Disclosure*, 30 FINANCIAL ANALYSTS J. 14 (July–August 1974).

123 Blumberg, *The Public's "Right to Know": Disclosure in the Major American Corporation*, 28 BUS. LAW. 1025 (1973).

124 Sommer, *supra* note 117, at 37.

125 Thus, commissioner John Evans said it is the SEC's responsibility to use its legal powers to "encourage high ethical and moral standards of corporate conduct"; 303 BNA SEC. REG. & L. REP., May 21, 1975, at A-13.

126 *Id*

segment of the public might need to be protected against possible adverse action by the disclosing institution or its controllers. If statutes regulating securities issues are the most convenient place to add such disclosure requirements, then that is a proper legislative action, so long as the additions do not emasculate the original purpose of the legislation. While our proposed system concentrates on investor protection we acknowledge the wider goals that disclosure requirements may satisfy and have tried to allow for them within our system.

Before proceeding with a more detailed look at the reasons for disclosure we should first sketch an outline of what we mean by "disclosure" – *i.e.*, the what, to whom, and when dimensions, which will be expanded upon later in this paper. It is obvious that there are several dimensions to the disclosure concept which are logically severable but which may form part of a whole envelope that is seen in its totality as a protection for society. One dimension is the total extent of required disclosure whether in statutes regulating securities issues or in diverse other statutes, such as environmental protection legislation.[127] A second dimension, closely related to the first, is the focal point to which parts or all of the required disclosure are directed; the nature of the interests or functions of the recipient may largely dictate the extent of the disclosure required to that recipient, although we have already noted that securities commissions may be required to seek information which is of little concern to investors. A third dimension is the effective dissemination of the disclosed information in digestible form to those focal points.[128] An extension of this dimension is the dissemination to wider groups than the initial focal points, perhaps based on the belief that other elements in society, particularly the news media, may identify problems which have not previously been considered relevant. A fourth dimension is timing of the disclosure; stale news is no news. A fifth dimension is the remedies, actions or results foreseen as a consequence of the disclosure and, separately, of the requirement for disclosure. It is the totality made up of these dimensions which we view as "disclosure" and not just the extent of the information publicly available. With these dimensions in mind we can suggest the fundamental tenet that we believe lies behind all requirements for disclosure and thus answers the "why" question: if each interested societal element is apprised of sufficient facts with respect to any business then a

127 *See, Telling All, supra* note 121, for some indications of the embarrassment of corporations forced to disclose contributions made to foreign officials.

128 The indigestibility of "full" disclosure is at the root of some clarion calls for less disclosure, such as Kripke, *The Myth of the Informed Layman*, 28 Bus. Law. 631 (1973).

rational compromise between the competing interests which each element represents will be facilitated. There exist mechanisms within the society to ensure that such a compromise will ensue if the competing interests cannot all be satisfied at once.[129] Disclosure changes the dispute from one based on facts to one based on competing policy objectives. While this may seem simplistic, it is a useful starting place from which to expand on the purposes of disclosure.

Another point, based largely on Canada's tendency to adopt precedents in the securities regulation area from the United States, should be made here. If one accepts that corporations are the key business institutions in Canada today, then corporate disclosure becomes the central focus in any discussion of disclosure by business institutions. As we have already noted total required corporate disclosure will be much wider than the disclosure which could rationally be required of business institutions if the focus was purely on questions of investor protection.[130] One might expect that general requirements of corporate disclosure would be largely promulgated by the jurisdiction of incorporation in the constating legislation. But in any country where there are eleven incorporating jurisdictions[131] it is evident that, in the absence of uniform legislation, unevenness in corporate disclosure requirements would result. This may be appropriate for local businesses. Indeed with respect to those businesses it is logical to expect that local requirements should be controlling and such requirements may well differ between various localities. But with respect to businesses which either operate in more than one locality or whose influence pervades other localities the disclosure requirements must be acceptable to each such locality where interested societal elements are affected. Thus disclosure requirements in Canada are likely to be contained in statutes other than the basic corporate laws. Similarly, in the United States, where there is no federal incorporation power,[132] the disclosure requirements for corpora-

129 In the securities regulation area, *see* Knauss, *supra* note 83.

130 Although if a standard is drawn widely enough, quite full disclosure can be obtained under the concept that a corporation must reveal all "facts which a reasonable shareholder might consider important", which was the standard set by the 7th Circuit Court of Appeal in 1975. That standard has now been cut back by the United States Supreme Court in TSC Industries v. Northway Inc., 90 S. Ct. 2126 (1976). *See also* Whitmore, *Why Wider Disclosure Is Good for Business*, The Times (London), June 24, 1976.

131 This problem is exacerbated in the United States where there are 50 incorporating jurisdictions, the most popular of which for large corporations is likely little Delaware, the statutes of which tend to be highly management-oriented.

132 Federal incorporation in the United States has been recently proposed but is not without its critics and is likely some years off yet; *see* report of the ABA Symposium in 307 BNA Fed. Sec. L. Rep., June 18, 1975, at A-1.

tions with more than local activities are contained mainly in the federal securities laws. While those disclosure laws have been justified on the basis of investor protection, it is suggested that those disclosure requirements are also seen as the general disclosure requirements for public corporations in the United States. The protection of the investor could be therefore just one of many societal goals which the disclosure requirements of the U.S. statutes seek to protect.[133] We do not wish to suggest that securities legislation is an inappropriate place to centre most corporate disclosure, including disclosure required for purposes other than investor protection. We do suggest however that the result would be in Canada, and has been in the United States, that the reasons for the extent of the disclosure required are masked if one pretends that investor protection is the only goal. No doubt there could be a Canada business disclosure act which would fulfil the same disclosure purposes as we suggest in this paper and indeed the Corporation and Labour Unions Returns Act now fulfils this function to some extent. However, we assume that the disclosure requirements that might be contained in such a statute are to be embodied in the Canada Securities Act as this approach is consistent with the developing practice in the United States[134] and in the various provinces of Canada. That the disclosure is not just for investor protection has been more clearly articulated in the recently proposed Australian legislation[135] than it has been in either Canada or the United States.

As a further introductory point, it should be noted that disclosure, by itself, is now generally acknowledged to be an insufficient regulator of the securities markets.[136] In the following section of this paper we have explained in some detail the augmentation of a basic disclosure system by direct regulation through an appropriate regulatory body. Direct regulation may be necessary, for example, where each individual investor has an insufficient economic interest to justify any effort at concerted action, yet the combined investment is significant. One example of this would be the promulgation of rules for the trading of shares in the secondary market. In other areas, there may be a public policy against permitting any solicitation of funds from the public except on

133 For a readable overview of the U.S. provisions, *see* Ruder, *Federal Restrictions on the Sale of Securities*, 67 Nw. U.L. Rev. 1 (1972 Supp.).

134 *See Hearings on H.R. 10570 and H.R. 13986 before the Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce*, 93d Cong., 2d Sess. (1974).

135 *See* speech of Senator Murphy, *supra* note 120.

136 Knauss, *supra* note 83.

terms approved by the government directly. Lotteries are an obvious example.

A. PURPOSES OF GENERAL DISCLOSURE REQUIREMENTS

Turning to the purposes themselves, we can say that to the extent disclosure under a proposed federal statute is viewed as general disclosure of information which ought to be publicly available with respect to large enterprises[137] operating in Canada, regardless of whether such disclosure protects the investor or not, then the broad purpose of all disclosure legislation, stated above, becomes more meaningful. The public availability of information as to quality of performance of specific business enterprises should provide interested sectors of society with the facts to commend or condemn that performance. As a corollary to the public availability of facts, the requirement of disclosure will ensure that senior management officers of business enterprises are themselves apprised of those same facts, which in itself may be a healthy discipline. It is self-evident that steps taken within an enterprise to ensure compliance with standards that are acceptable to the general public are more effective than any judicial or quasi-judicial regulation that might be imposed to enforce such standards.

Secondly, but also at the level of general business disclosure, a requirement of frequent, periodic disclosure should minimize the likelihood of corporate scandals or inappropriate corporate behaviour and contribute to law enforcement by facilitating detection of improper behaviour at an early stage. While it can be argued that improper behaviour will still occur but simply not be adequately disclosed, there is a huge difference between denying a knowledge of what constitutes improper behaviour once confronted with it, and denying that the behaviour in question was concealed. Additionally, we would suggest that most senior business officials are responsible citizens who are responsive to articulated standards. Without disclosure of the facts, it is difficult for the public through its elected representatives to articulate standards.

Thirdly, there is a widespread belief that we live in a secretive society.[138] Where information is not available, secrecy breeds dis-

137 If one considers only the needs of the investor, there may be a case for less disclosure by very large institutions as compared to smaller ones, at least at the time of additional issues of outstanding securities; *see* Schneider, *An Administrative Program for Reforming the Federal Securities Laws*, 23 Bus. Law 737 (1968).

138 J. Crispo, The Public Right to Know, Accountability in the Secretive Society (1975).

trust. Full disclosure dispels fears.[139] Thus a major purpose of any general disclosure requirement is to reinforce the public acceptability of existing societal institutions by providing the information to refute charges of unacceptable behaviour. It is difficult for detractors to avoid the label of irresponsibility if readily available information exists which proves the contrary of their assertions. Without such information the hand of the dissident is strengthened.

Fourthly, there is the purpose of equality of opportunity.[140] This is sometimes phrased as a negative – that one should not take advantage of information which is confidential. But phrased that way, the reprehensible conduct is seen as breaking, or using to one's own advantage, a confidence reposed in the user by a third party. Seen in the more positive ethic of equality of opportunity the reprehensible conduct is seen as taking advantage of a situation of which others, if they had knowledge of the facts,[141] are equally entitled to take advantage but are precluded from so doing because of their ignorance.

These four purposes are sufficient to justify a statutory requirement of general disclosure by business enterprises, which disclosures would obviously have some elements of vital concern to investors. But so to state only begs the real questions for no dimensions have been put into the general disclosure requirement. What information must be disclosed? To whom are the various bits of required information directed? By what means is the information to be disseminated?[142] When and how often is the information to be disclosed? What are the anticipated results? At least some of these questions should be addressed at this point. The extent of the information to be disclosed must be balanced against two fundamental principles:

(1) There are competing values in the society which protect the non-disclosure of certain information or require disclosure only on the basis of restraints on use of the information by others.[143] Thus it is fundamental that trade secrets, such as the formula or process used to manufacture a patent medicine or a soft drink, may be kept confidential by the business enterprise involved, although confidential disclosure to health authorities may be required in some instances. Like-

139 *Hearings on H.R. 10570, supra* note 134, at 23 (statement of Philip A. Loomis).

140 *See* Knauss, *supra* note 83.

141 Cohen, *A Guideline for Equalizing Investment Opportunity: Avoiding the Pitfalls of Selective Disclosure*, 46 S. Cal. L. Rev. 139 (1972).

142 Some of the possible media are discussed in Bromberg, *Disclosure Programs for Publicly Held Companies - A Practical Guide*, [1970] Duke L.J. 1139, 1167.

143 *Id.*

wise, letters patent of invention are granted on the basis of disclosure of the invention to the public but denial of public use of the disclosure, within certain limits. Similarly where complete disclosure would put the discloser at a disadvantage vis-à-vis his competitors then the disclosure principle may yield to the equality of opportunity principle.

(2) The cost of the public obtaining each required item of information must at least equal the anticipated value of the disclosure of the information so obtained.[144] While a cost-benefit analysis is neither desirable nor practical for each individual item of information required, there are some items where the costs of obtaining the information are significant. Such items are usually identifiable by the enterprises involved and they can be relied upon to complain if specifically invited so to do.[145] More fundamental however is the general recognition that the public will ultimately bear the full cost of any required disclosure. Business enterprises are simply intermediaries. They obtain funds from the public through sales to consumers of their products and expend these funds on their employees, their security holders or, through taxes, on the government. If costs rise then either the consumer will pay more for the product or the wages of employees, returns on invested capital or taxes must decrease. In any case it is the public, or a substantial portion thereof, that pays the cost. Put another way, the cost of disclosure is inflation as no extra consumable product is produced for the extra cost involved.

These two factors should not be blown out of proportion so that only minimal disclosure requirements are enacted but, where significant new costs may result, additional disclosure requirements should be preceded by a careful cost study.

Of equal importance to the extent of disclosure is the focal point to which the information is disclosed. To some extent, general public disclosure can be obtained by filing the material in a central depository with only an indexing system.[146] Assuming complete disclosure, the utility of the disclosure then varies directly with the sophistication of the indexing system. Often the repository of the information has at least some responsibility to check that the facts disclosed appear to comply with the disclosure

144 *See* Notice of Public Proceedings on Corporate Disclosure of Environmental Impact, SEC, Securities Act of 1933 Release No. 5569, February 11, 1975, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 80,110.

145 One example is the various voluminous briefs submitted to the Ontario Securities Commission at each of its several stages of attempting to attain agreement on a new securities statute.

146 This is essentially the British system, although query the indexing system.

standards imposed. If, as is sometimes the case, the person to whom the information is disclosed has some obligation or possibility to act on the information, then the information disclosed might be limited to the interests of the recipient so he is not sorting through irrelevant information and, perhaps, the amount of information should vary with the ability of the recipient to understand the information.[147] This concept, sometimes called "differential disclosure", is becoming generally accepted in the United States.[148] The furnishing of excess information to the uninterested or incapacitated is a waste that the system can ill afford. But lack of ability to understand on the part of the recipient should not preclude all disclosure to that recipient – the disclosure should be put in terms that he can understand.[149]

Allied to the question of to whom the disclosure is directed and particularly to the question of differential disclosure is the question of the dissemination techniques to be employed.[150] Traditionally, expositive material has been disseminated by means of written communications, a medium which relies on the recipient to read what is received. While it is realistic to expect people whose livelihood requires that they digest such material to make the effort to understand it, even if the phraseology is somewhat obtuse, it may be unrealistic to expect members of the public to be equally motivated.[151] Thus, for example, the current consensus appears to be that investors seldom if ever read lengthy disclosure documents such as a prospectus.[152] It is even doubtful if shareholders read information circulars. It is more likely that shareholders at least look at annual reports,[153] especially if the reports are set up in a fashion to catch the eye.[154] Even then one wonders if anything

147 The GLADSTONE COMMITTEE REPORT in 1844 stated that the greatest benefit of disclosure would probably be derived by those "professionally employed in making investments to learn more easily and accurately the real nature of these companies"; *quoted in* B. HUNT, supra note 19, at 94.

148 Although a countervailing consideration is the problem of "selective" disclosure which the courts have criticized when information is made available to one set of analysts and not another; Gillis, *Trends in Disclosure*, 32 FINANCIAL ANALYSTS J. 8 (January-February 1975).

149 Sommer, *Random Thoughts on Disclosure as "Consumer" Protection*, 26 BUS. LAW. 85, 91 (1971).

150 Thus H. CHERRINGTON, *supra* note 56, at 150 complains that the gathering of information by "blue sky" commissions before 1933 was of little consequence to the investor because the information remained hidden away in commission offices.

151 Kripke, *supra* note 128.

152 Indeed, full disclosure has been said to defeat fair disclosure; *see id.*

153 The chairman of the SEC on March 13, 1974, wondered if the annual report contents should become subject to more detailed requirements; *see* SEC News Digest, March 14, 1974. It is interesting to note that the least regulated document, the annual report, is the most widely read.

154 Corporate advertising is clearly one way of bolstering investor relations; *see* South-

but the pictures, captions and perhaps the president's letter are perused.[155] Certainly many investors lack the expertise required to read the financial statements.[156] In short, the less motivated the recipient the more ingenious the dispatcher if there is to be effective communication. Naturally ingenuity comes at a high cost. Increasing the amount of information which it is mandatory for enterprises to send to a large number of passive recipients is of questionable value. More disclosure to a select audience who in turn have access to warmer media if the disclosure so warrants is likely a more fruitful approach. But the cry for public disclosure suggests that this process will be evolutionary not revolutionary.[157]

Considerable attention has been focussed in recent years on the timeliness of disclosure.[158] This has been manifested, for example, in requirements for increased frequency of financial reporting and in requirements of regulatory authorities, including stock exchanges, for immediate disclosure of material information. In addition to the cost-benefit question and the problems of adequate dissemination techniques, two countervailing policies must be balanced against the concept involved in immediate disclosure:

(1) Premature disclosure may raise expectations which in fact are not fulfilled. In the securities markets, this is likely to cause exaggerated fluctuations in prices, which fluctuations usually hurt the little investor. In addition, unnecessary portfolio churning may result with attendant service costs. In the environmental protection area, unnecessary concern may generate a lot of wasted time.

(2) Reactions by other enterprises, especially where the disclosure suggests a large potential for profit, will likely lead to an inefficient allocation of resources in the ensuing scramble for participation. The entrepreneur or enterprise that had the good fortune or wisdom to sow in fertile fields is entitled to

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ern, *Can Corporate Advertising Help Your Investor Relations Program*, PUB. REL. J., November 1974, at 20.

155 As Hurst puts it: "The most tangible accomplishments of the [disclosure to shareholders] movement were to make management more aware and more adept at the polite forms of relations with shareholders"; J. HURST, *supra* note 7, at 97.

156 *See* the recent proposal to require auditors to ensure that there is "fair representation". Does this mean understandable? *See* Slain, *Fair Representation*, 8 REV. SEC. REG. 982 (January 29, 1975).

157 Lowry, *Lord Mansfield and the Law Merchant*, 7 J. ECON. ISS. 611 (1973), mentions a report by Cicero of an argument between Diogenes and Antipater in which Antipater felt that the seller's obligation to society was to "tell everything, so that the buyer can be just as much in possession of the facts as the seller" while Diogenes felt the seller was only bound to make no misrepresentations. *Plus ca change, plus c'est la meme chose.*

158 *See e.g.* Bromberg, *supra* note 142.

reap the harvest in the absence of some unfair dealing or social policy to the contrary.

In the securities area, it is argued that slow disclosure may provide opportunities for those with advance knowledge to make unfair gains.[158a] This could be prevented by adequate insider trading rules. It is also argued that lack of disclosure can prejudice any person dealing directly with the enterprise or with securities of the enterprise. Thus additional trade credit might not be available if negative prospects were announced promptly. But if in fact those prospects did not develop, the enterprise would be denied otherwise available credit on the basis of a supposition which, with hindsight, proved wrong.

Finally, the results expected from extensive disclosure should be considered. It could be argued that positive increases in efficiency are likely to be produced in the overall system. Even if there are not, it may be that sufficient prevention of improper behaviour will occur to justify the effort required. Certainly psychologically the society will feel better equipped to deal with changing economic realities, which in itself is probably a sufficient result to justify considerable disclosure requirements tailored within the parameters outlined above.

B. PURPOSES RELATED SPECIFICALLY TO INVESTOR PROTECTION

Leaving the question of general disclosure by business enterprises and turning to the specific disclosure requirements for investor protection which are the primary focus of this paper, there are two major, purely investor-related reasons for significant disclosure by business enterprises which seek funds from the public or which have sought funds from the public in the past with the result that their securities are currently traded in the public marketplace. These two reasons are:

(1) to facilitate the effective assessment by investors or prospective investors of the value and price of securities offered for purchase or sale in the marketplace;[159]

(2) to contribute to the effective use by security holders of their voting rights, or other contractual or statutory rights that they may have as security holders.[160]

158a *See* the remarkable judgment of the Ontario Securities Commission in *In re* Harold P. Connor, [1976] OSC Bull. 148 (June).

159 This is sometimes subdivided into providing opportunities for sophisticated analysis by those capable of so doing and providing warning signals for the unwary; *see* Anderson, *supra* note 119.

160 The Ontario commission has held that annual reports are useful to debt as well as equity holders and therefore should not be discontinued merely because all the

While there are other subsidiary reasons for requiring certain types of disclosure, such as insider trading reports and market trading data, we will first consider these two fundamental reasons.

It has been obvious for at least 250 years that an unregulated securities market with uninformed investors leads to chaos.[161] As we have earlier indicated, the advent of modern corporation legislation in the middle of the nineteenth century providing for easy incorporation was coupled with requirements for disclosure by corporate entities, particularly where they sought to interest the public[162] in investing in the enterprise. The concept then, as now, was based on the assumption that only an investor who was provided with adequate information could make a rational decision as to whether he should expend his funds in purchasing an available security. That the focus of securities disclosure has been on a purchase of a security at the time of initial issue can be rationalized in two ways. First, the secondary market is really only an adjunct of the primary market.[163] Its function is to facilitate trading in already issued securities which thereby allows any investor the freedom to dispose of his original investment before its maturity date. The ready marketability of a security makes it a liquid asset, which is a decided advantage from the investor's point of view. Indirectly there is an advantage to the issuer as the existence of a trading market ensures that people with money available only on a short-term basis can, if they choose, invest in securities with long-term maturities. This is particularly important with respect to common shares where the investment is, in theory, permanent if no trading market exists. Nevertheless, in terms of the basic economy of a country, only new infusions of money on primary issues result in increased capital in the operating sector. Accordingly, the necessity of full disclosure to investors so that available new capital would be efficiently allocated within the operating sector was more important to the overall economy than was disclosure at the time of secondary transactions. Secondly, a new issue normally results in substantial purchases of identi-

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shares are controlled by one group; *see In re* Toronto-Dominion Centre Ltd., [1975] OSC Bull. 139 (April).

161 *See* C. MacKay, *supra* note 15, for an interesting account of the frauds of the early eighteenth century.

162 The "public" is a very difficult term to define. This is discussed later in this paper. For present purposes, we shall presume that we are dealing with cases where the term "public" is obviously not a limiting factor. For a recent discussion *see* the decision of Judge Wong in R. v. Kiefer, B.C. Corporate & Financial Services Division Weekly Summary, May 14, 1976, at 2 (Prov'l Ct.).

163 This interrelation of the primary and secondary markets was espoused in the Kimber Report at 8.

cal securities by investors within a reasonably short period of time. Thus it is practical to require an enterprise as a condition of selling a substantial amount of securities, to bear the cost of preparing and disseminating information to would-be purchasers. On a secondary sale the issuer gets no direct benefit while the seller lacks access to the necessary information regarding the issuer to make it sensible to put the burden on him at the time of sale. That this problem does not obtain when the seller in fact is in control of the issuer, explains in part the requirement of disclosure on a secondary-primary, which has been a feature of Canadian securities legislation for decades.

A continuous flow of new primary share issues inevitably meant that shares available for trading in the secondary market increased. Indeed it was to be expected that the dollar volume of trading in the secondary market would exceed the dollar volume of trading in the primary market in any given year. Today the dollar volume of trading in shares in the secondary market so far overshadows the dollar volume of new issues that a prospective investor is much more likely to invest through the secondary market than through the primary market. Accordingly, if the reason for disclosure is to facilitate the effective assessment by investors of the value and price of securities, it is obvious that disclosure must be made to investors in the secondary market. The answer to the question of who should supply the information is equally obvious – the person who knows or has access to the facts. The answer to the question of who should bear the cost of assembly and dissemination of the facts is not so obvious. Under a continuous disclosure system, some data would be available to every potential purchaser. The cost of producing such continuous disclosure would probably be borne by the issuer. Information might also be available from research reports prepared by investment dealers for their clients, usually at no direct cost to the client. If a more direct burden were put on the purchaser to inform himself before purchasing on the secondary market then the cost of entry into the market as an investor would preclude the small investor from entering the market at all. If a similar burden were imposed on the seller, then the cost would cut into his return on the sale of the securities in question. Accordingly, if a more direct disclosure is to be made on secondary market transactions, the cost must be borne by a third party, which, inevitably, will spread those costs onto the segments of the public from which his sources of funds are derived. The two most likely candidates as the intermediary cost absorbers are the original issuer of the securities[164] and the trad-

164 *See*, Jacobs, *Disclosure by Nontraders*, 8 Rev. Sec. Reg. 911 (May 21, 1975).

ing houses[165] whose livelihood depends on the existence of the secondary market. The allocation of the responsibility and hence the cost of disclosure as between these two institutions will be further adumbrated later in this paper. At this point we simply wish to emphasize that the primary reason for disclosure to the investor forces a solution which may be difficult to accept in all its ramifications. It may well be that further evolution of the securities markets themselves will lead to a more easily acceptable solution but that is beyond the scope of this paper.

The second major purpose of disclosure in the securities regulation area is to contribute to the effective use of the contractual and statutory rights which the security holder has with respect to the issuer.[166] The most obvious right is the right of the common shareholders to elect the directors of the company. While it has been recognized since at least 1932[167] that shareholders in a corporation whose shares are widely dispersed have no effective control over the election of directors,[168] various devices have been invented to ensure that minority views can be ventilated. Such ventilation may directly influence the direction in which the management of the corporation is headed or may result in government action or castigation of the corporation concerned by the media. The media may themselves be the instigators if the business enterprise is required to publicly disseminate information. This is a good example of dissemination beyond the focal point (*i.e.*, the securityholders) having a potential for positive effect.[169] To inform the securityholder on a regular basis of material facts concerning the issuer of those securities has been the major development in North American disclosure requirements over the past ten years. The ready availability of such information has had the important consequence of partially fulfilling the need of the potential investor in the secondary market. While the disclosure requirement was premised on the informational needs of existing shareholders, it serves another useful purpose.

165 Municipal bond dealers in the United States now have the burden of making full disclosure to their clients; *see Big Board Likes Securities Bill*, The New York Times, May 27, 1975.

166 It is, of course, difficult to get information to beneficial as opposed to nominee holders, although efforts in this regard are increasing; *see* 290 BNA Sec. Reg. & L. Rep., February 19, 1975, at A-2. It may be that such holders, by holding through nominees, have already evidenced that they are not interested in receiving any information.

167 A. Berle & G. Means, *supra* note 57.

168 1 L. Loss at 12.

169 Similarly, insider trading reports are often noted by the press which gives shareholders indirect knowledge of the contents of the reports; *see* Knauss, *supra* note 83, at 633.

Subsidiary reasons for disclosure in the securities area really relate to the application of the general reasons for disclosure, discussed above, to the securities markets. Thus insider trading reports may disclose improper behaviour on the part of insiders or at least give the regulatory authority some basis on which to base an inquiry. That present insider trading legislation has been labelled "impotent"[170] is more a result of the substantive and administrative difficulties than it is of the disclosure requirements. Similarly, periodic disclosure by brokers of their financial position ensures compliance with minimum capital requirements and allows the authorities to formulate new regulations consistent with the evolving requirements of the industry.

C. CONCLUSION

In conclusion, for the reasons set out above, we believe that detailed disclosure by business enterprises is essential but that care must be taken in the formulation of rules to ensure that the regulatory pattern reflects a balance of the benefits to be gained against the costs and other burdens involved. Specifics of the existing disclosure requirements in the securities area and our suggestions for changes are set out later in this paper. Before turning to that area, we wish to discuss the recognized supplementation of the disclosure requirements in the securities regulation area, namely, regulatory intervention where complete disclosure still leads to inadequate investor protection.

Chapter IV
Supplementation of Disclosure by "Blue Sky" Rules

It is generally agreed that disclosure requirements, no matter how far-reaching and how widely disseminated, are not in themselves an adequate system of regulation for the securities industry.[171] In Australia, the United Kingdom, the United States and Canada, there is some system which limits the ability of potential issuers to sell their securities to the public, regardless of how much they disclose. Some restrictions may be based on a belief that the financial markets cannot absorb all the issues desired to be marketed with the result that priority may be given to certain types

170 By the Minister then responsible for the Ontario legislation; *see* the Globe and Mail (Toronto), June 11, 1969.

171 *See* L. Loss, Proposal for Australian Companies and Securities Legislation: Comments from the American Experience (July 13, 1973) (Report tabled by the Attorney-General of Australia in Senate, September 12, 1973), CCH AUST. SEC. L. REP., Special Report, September 20, 1973.

of financing.[172] But more generally such restrictions are placed on issuers going to the public marketplace through a discretionary veto power vested in an administrator, such discretion to be exercised on the basis that the issue itself, or the issuer's plan, is not appropriate for submission to the public. The administrator in whom the discretion resides is given the power to preclude, either on the basis of a general discretion or on the basis of particular standards set forth in the legislation. The justification for the imposition of such a "blue sky" regime inevitably rests on the degree of protection which it affords to the investing public.[173] In this paper we will not deal with the anti-fraud provisions pursuant to which brokers or issuers who engage in any artifice to defraud are investigated or prohibited from trading, although those provisions are commonly subsumed under the "blue sky" heading in the literature.[174] Nor will we deal with provisions requiring licensing of certain persons engaged in the securities business although it is clear that denial of a licence to trade in a given security, if a licence is required before trading takes place, is effectively direct regulation over that security.[175] Our concern is the general discretion granted to an administrator to refuse to permit a primary issue of securities to go to the public at all.[176]

172 Thus, in the United Kingdom, permission must be obtained from the Bank of England before a new issue can be marketed. In effect, there is a queue of private enterprises seeking to release new issues.

173 1 L. Loss at 35. For an interesting article on state regulation, *see* Mofsky, *Reform of the Florida Securities Law*, 2 Fla. St. U.L. Rev. 1 (1974).

174 L. Loss & E. Cowett, Blue Sky Law (1958) is the basic text in the United States.

175 A cease trading order is likely the most effective form of direct regulation but appears to be somewhat overworked in Ontario at least. A list of outstanding cease trading orders appears in [1976] OSC Bull. 123 (June). The list goes on for 26 pages and comprises over 500 companies. The orders are based on 144(1) of the Ontario Securities Act which simply provides:

> "The Commission may, where in its opinion such action is in the public interest, order, subject to such terms and conditions as it may impose, that trading shall cease in respect of such securities for such period as is specified in the order."

This provision is carried forward unamended into Ontario Bill 98, s. 122(1). For examples of orders and reasons given, *see In re* Capital Growth Real Estate Fund, [1970] OSC Bull. 117 (August); *In re* Toronto Star Ltd., [1971] OSC Bull. 17 (February); *In re* Gray Industries Inc., [1971] OSC Bull. 15 (January); *In re* Canusa Holdings Ltd., (Can.), [1971] OSC Bull. 173 (October); *In re* Rodney Gold Mines, [1972] OSC Bull. 159 (July); *In re* Belgium Standard Ltd., [1973] OSC Bull. 94 (July). The courts have not reviewed many cease trading orders and when they have, there has been a reluctance to interfere with a commission's decision. For an interesting case where the court did interfere *see* Re Chromex Nickel Mines Ltd., 16 D.L.R. (3d) 273 (B.C.C.A. 1971). The Supreme Court of Canada quashed an appeal in the *Chromex* case on the ground that the Court of Appeal judgment was the exercise of a discretionary power; *see* Hretchka v. Attorney-General for British Columbia, [1972] S.C.R. 19, 19 D.L.R. (3d) 1 (1971). Cease trading orders are dealt with in *Leigh*

176 We will ignore the corresponding stop trading orders, discussed in *Leigh*, ch. I.E.

In the Canadian provincial legislation in force today from Ontario westward the discretionary provision takes the following form:

> "The Director may in his discretion issue a receipt for any prospectus filed under this Part, unless it appears to the Director that...[then follows a list of six situations, two of them further subdivided into three subheads each]."[177]

From Québec eastward, the provisions take a variety of forms but all explicitly grant to an administrative authority a discretion to determine whether or not the securities in question may be sold to the public.[178] The basic question for any jurisdiction is the appropriate degree of permitted discretion. The answer may well depend on the articulation of standards and the availability of an appropriate review procedure where the discretion is exercised against a particular issue of securities. In Ontario Bill 98, the director is required to issue a receipt for the prospectus unless "it appears to him that it is not in the public interest so to do" but, if any of eight listed situations occur, he is required not to issue a receipt.[179] There are appeal provisions provided both to the full commission and from the commission to the Supreme Court.[180] But there is no articulation of the general public interest standard. Even in the eight listed situations there is considerable discretion.[181] These eight grounds are:

177 Ontario Securities Act, s. 61; Manitoba Securities Act, s. 61. The Alberta Securities Act, s. 61 is identical except the "Director may in his discretion direct the Registrar to issue...". British Columbia has only five listed situations. Saskatchewan specifically provides "in its absolute discretion".

178 The Quebec Securities Act, s. 50, reads:

> "The Commission, whenever it deems it expedient, may grant such permission subject to such conditions as it may impose."

The Newfoundland Securities Act, s. 18, the Nova Scotia Securities Act, s. 17 and the Prince Edward Island Securities Act, s. 11 provide:

> "If it appears to the Registrar that a [registration statement] is incomplete, inaccurate or unsatisfactory in any respect the Registrar may..."

The New Brunswick Securities Act, s. 17 provides:

> "If..., The Board finds [the documents]...provide a fair, just and equitable plan for the transaction of business, it may issue to the company a certificate..."

179 Ontario Bill 98, s. 62.

180 Ontario Bill 98, ss. 8, 9. In view of the *Hretchka* case, *supra* note 175, it is doubtful if an appeal would lie from the Ontario courts to the Supreme Court of Canada.

181 Baillie, *supra* note 91, at 220 discusses the whole area, pointing out how significant the discretionary powers are. While the OSC took the view that the discretion was only exerciseable in the listed circumstances, this seems contrary to the express wording of both the old and the new sections. In some recent decisions, the "residuary" discretion under the public interest clause has been expressly recognized; *see In re* Galaxy Gold Mines Ltd., [1975] OSC Bull. 57, 60 (February); *see* to the same effect the decision of the Quebec Securities Commission in Re Farmex Enterprises, 5 QSC Bull., No. 30 (decision No. 4288, July 30, 1974).

(1) The prospectus or accompanying documentation
   (a) fails to comply in any substantial respect with the statutory requirements;
   (b) contains information that is misleading, false or deceptive; or
   (c) contains a misrepresentation,
(2) An unconscionable consideration is or will be paid for property or promotional purposes,
(3) The proceeds of the proposed issue together with other resources of the issuer are insufficient to accomplish the purposes set out in the prospectus,
(4) Considering the financial position of the issuer and its insiders, the issuer cannot reasonably be expected to be financially responsible,
(5) Past conduct of the issuer or its insiders affords reasonable grounds for the belief that the business will not be conducted with integrity,
(6) Such escrow arrangements as the director requires have not been entered into,
(7) In the case of a prospectus of a finance company,
   (a) the plan of distribution is not acceptable;
   (b) the offered securities are not secured in the manner required in the regulations;
   (c) the issuer does not meet the financial and other requirements set forth in the regulations,
(8) Any expert's report or valuation has not been prepared by an expert acceptable to the director.

While the opinion content in these eight enumerated heads for rejection is apparent, it is difficult to quarrel with the concepts or to suggest more clearly defined criteria.[182] Because of this difficulty in reducing the discretion to a set of simple, acceptable rules, it is absolutely essential that the persons exercising the discretion be sufficiently able and experienced to merit the confidence of the securities industry.[183] Even then the residuary standard of "the public interest" is too broad. It is not even clear which portion of the "public" is to be considered. It is suggested that a residuary standard of "when the commission decides, after a hearing, that the protection of the investing public in Canada so requires" would be sufficiently wide.

In a federal system, the question arises of where the "blue sky" discretion should rest. In the United States, the federal legislation anticipated that a state "blue sky" regime would con-

182 *See* WINDFALL REPORT at 96; Emerson, *supra* note 67, at 413-16.
183 *See* PORTER REPORT at 345.

tinue.[184] But this has resulted in very unequal investor protection as between the various states due to differing legislative philosophies. Such a divergence of philosophy is perhaps less likely in Canada. But there are several cogent reasons why the "blue sky" jurisdiction, at least for issues sold in several provinces, should be at the federal level. The first and most obvious is to ensure uniform application of at least minimum standards, regardless of the province of origin of the issuer. The second reason has already been alluded to, namely the necessity of hiring capable administrators. It is doubtful if the provinces, particularly the smaller ones, should be asked to strain their limited financial resources in order to provide such a wealth of talent. It is equally dubious whether ten persons of that quality should be expended on a job that two or three could adequately cope with on a centralized basis. The third major reason for including a discretionary authority at the federal level is the flexibility then afforded to the provinces. If any province felt that an adequate job was being done at the federal level it could opt out of the field entirely while, if any province felt otherwise, it would be free to impose additional requirements.[185] With respect to purely intraprovincial issues, any province which chose to remain in the field should retain full "blue sky" powers over such issues and the federal administrator should not be involved. If any province did decide to opt out of the field entirely, the federal administrator should then exercise the discretionary authority.

If we assume a federal discretionary authority then appropriate rights of appeal should be provided for. It is suggested that the commission, not the director, would be the initial decision-maker under the residuary authority. The director, or his counterpart, would be the initial decision-maker under the enumerated heads. The appeal provisions set forth in the proposed Ontario statute would be suitable for adoption, substituting the Federal Court of Canada for the provincial courts, but there should be some system whereby really important matters could be appealed to the Supreme Court of Canada. In view of that court's power over its own docket, the appeal would be available only by leave of the court. But the possibility should be there.

In considering the application in practice of the exercise of the discretionary jurisdiction, the most frequent case where judg-

184 1 L. Loss, ch. 1B.

185 If the stock exchanges are permitted to engage in primary distributions at all, then another strong reason for a federal presence is present in order to promote uniformity between stock exchanges; *see* Special Report on the Rae Report, CCH Aust. Sec. L. Rep. 3 (July 18, 1974).

ments of that sort are required are in the "hot issue" market[186] and in speculative mining issues.[187] A considerable body of experience has been gained by the provincial securities commissions in the problems relating to mining issues and this expertise should be utilized. While the speculative mining issues are largely a gamble,[188]numerous regulations and policies have been introduced to ensure that the gamble is as fair as possible.[189] On the other hand little attention has been given to the "hot issue" problem, at least at the level of "blue sky" type regulation.[190] A "hot issue" is an offering of securities where the whetted demand exceeds the available supply with the result that a substantial premium develops quickly in the immediate aftermarket.[191] The most effective way to stop a fictitious whetting of demand may be to slow down the issue in order to give the facts a chance to catch up with the fancy. While we do not propose to go into this question in detail, it does seem appropriate to lodge a discretion in the federal commission specifically tailored for this situation.

Refusal to accept a prospectus has been used by the provincial securities commissions for years as a way to force issuers to conform to whatever policies the securities commissions wish to promulgate. Not only is the securities bar reluctant to challenge such a use of the administrative process[192] but the then Minister of Consumer and Commercial Relations in Ontario used this ruse as the basis for implementing a policy control over Mortgage and Real Estate Investment Trusts.[193] It is submitted that a direct rule-making power must be included in the statute if policy statements are to be issued in such a grand manner. Hiding behind a "blue sky" discretion is entirely inappropriate. This is not to deny that certain segments of the securities industry need a much more detailed regulatory base than other segments, but such direct regulation should be dealt with separately from the

186 *See* Prifti, *The Hot Issue*, 24 Bus. Law. 311 (1968).

187 *See* Ontario Securities Commission, Study of the Financing of Mining Exploration and Development Companies (1968) (Beatty Report).

188 *Cf.* Windfall Report.

189 *See* National Policy No. 2, August 1974, 2 CCH Can. Sec. L. Rep. ¶ 54-839; National Policy No. 22, April 1971, 2 CCH Can. Sec. L. Rep. ¶ 54-859; OSC Policy No. 3-02, April 1, 1976, *as amended*, 2 CCH Can. Sec. L. Rep. ¶ 54-896; OSC Policy No. 3-03, April 5, 1971 *as amended*, 2 CCH Can. Sec. L. Rep. ¶ 54-897.

190 There has been some regulation of the brokerage fraternity in the United States; *see* CCH NASD Manual ¶ 2151.06.

191 Sowards & Mofsky, *The "Hot Issue": Possible Hidden Causes*, 45 St. John's L. Rev. 802 (1971).

192 *See* Lockwood, *Procedure in Cross-Country Prospectus Clearance and Regulation by Policy Statement*, in Law Society of Upper Canada, Special Lectures: Corporate and Securities Law 111, 119 (1972). In some situations, the technique has beneficial results but its indiscriminate use is an abuse of the administrative process.

193 [1972] OSC Bull. 181 (September).

general "blue sky" discretion.[194] Indeed in some cases, regulation by an authority other than the securities commission is indicated.[195] If such be the case, it is essential that the regulated industry be subject to only one master or at least that it not be subjected to conflicting requirements. It should also be mentioned that it is totally inappropriate to have some enterprises within a regulated segment subjected to more onerous requirements because they are obliged to file a prospectus every year (such as open-end mutual funds) while others within the same segment (such as closed-end funds) are subjected to less stringent regulation.

A final point that should be raised in the "blue sky" area is the role of the stock exchanges. It is evident that if primary distributions through the stock exchanges are preserved,[196] then the stock exchanges are in a position to impose their own form of "blue sky" regulation. Even without primary distributions over the exchange, the refusal of a listing application is an additional form of direct regulation. While it is not the purpose of this paper to examine the interrelation of the stock exchanges and the commission, we do note that it would be inappropriate to have less regulation on a primary distribution over the stock exchange.

Chapter V
Current Canadian Position

> Writing in 1964, Ontario Chief Justice Dana Porter said: "One of the principal objectives of some of the administrators and practically all the brokers, dealers and corporation lawyers is uniformity of [securities] legislation across Canada. Some faltering progress is being made...."[197]

Twelve years later, the elusive goal of uniformity appears to be still some way off although considerable progress has been made.[198] Accordingly, in describing the current Canadian position, we will attempt to cover the 1975 legislation by subject matter rather

194 An obvious example is the mutual fund industry and the authors have already made a detailed study in this area, which has not yet been acted on; *see* MUTUAL FUND PROPOSALS.

195 For example, with insurance companies in Canada, particularly when one considers the older constitutional law decisions and the existing administrative structure now in place.

196 As they are in Ontario Bill 98, s. 74(1)(b).

197 PORTER REPORT at 345.

198 One can hardly fault slow action by the provinces when juxtaposed to inaction at the federal level. One might hope that the provinces would pursue the uniformity issue

than to explain the provincial systems *seriatim*. As the Ontario system has been adopted in all the western provinces[199] and there is less uniformity in the east, Ontario will be used as the bench mark.

A. PROSPECTUS FILING REQUIREMENTS

The natural starting point is prospectus filing requirements, as the prospectus has been the fullest disclosure document required by the statutes since 1844. Subsection 35(1) of the Ontario Securities Act provides:

> "No person or company shall trade in a security either on his own account or on behalf of any other person or company where such trade would be in the course of distribution to the public of such security until there have been filed with the commission both a preliminary prospectus and a prospectus in respect of the offering of such security and receipts therefor obtained from the director."[200]

To understand this subsection one must be cognizant of the statutory definitions of "trade", "security" and "distribution to the public" because none of them is in accordance with normal English usage. "Trade" includes a negotiation, solicitation or any attempt to sell a security. "Security" includes, as well as what most people think of as a security, *inter alia*, a natural gas lease. "Distribution to the public" includes all primary and secondary distributions of securities to the public which have not been previously so distrib-

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more vigorously rather than embark on substantial revisions to the existing system, whose major weakness is its lack of uniformity.

199 This is not a new phenomenon. In 1964, Alberta, Saskatchewan and British Columbia had copied the Ontario legislation; *see* PORTER REPORT at 345.

200 Alberta Securities Act, s. 35, Saskatchewan Securities Act, s. 42 and Manitoba Securities Act, s. 35 are substantially identical, although Saskatchewan and Manitoba still use the old words "primary distribution to the public" which are slightly differently defined than the words "distribution to the public". This difference will be ignored. The British Columbia statute does not require a preliminary prospectus at all although B.C. Policy No. 3-03, April 5, 1971, 2 CCH FED. SEC. L. REP. ¶ 29-953, outlines a procedure for obtaining receipts for a preliminary prospectus on a "national issue". It has been a hallmark of the administration of securities regulation in Canada to attempt to make up through allegedly uniform policy statements for the lack of legislative uniformity. In fact, all the provinces now accept preliminary prospectuses although there is no provision for them in the east at all. This has been accomplished through cooperation between administrators who publish "National Policy Statements". The "national issue" requirements are set out in National Policy No. 1. A valuable table telling one what to file and where, is set out in Lockwood, *supra* note 192, at 125. Quebec has the most extra documents to file with the prospectus while Prince Edward Island and Newfoundland, not unexpectedly, have the least.

uted and also includes sales from persons whose total holdings materially affect control, whether or not the securities have been previously distributed to the public and whether or not the securities are of a class that has anything to do with control. Thus the requirement of filing a preliminary and final prospectus is much wider than an initial reading of the section might suggest. There are two important limitations; the distribution must be "to the public" and there are a host of exemptions. We will leave both of these limitations on when disclosure is required until we have sketched out the extent of the required disclosures.

The Ontario Securities Regulations[201] set forth in detail the requirements for prospectuses of prospective issuers,[202] while the statute itself sets out a requirement for full, true and plain disclosure.[203] At the end of each form is a requirement to "give particulars of any other material facts relating to the securities proposed to be offered". The use of the word "other" may be unfortunate as it suggests that all the enumerated items are "material" which in fact is not always the case. This catchall clause together with the statutory requirement for fullness gives another discretionary power to the commissions which often results in negotiations with the issuer before a prospectus will be accepted.[204] The relegation to the regulations or, better still, to commission rulings specifically authorized by statute, of the required content for whatever disclosure document is to be delivered to prospective purchasers is essential, especially in a federal statute, if flexibility is to be maintained.[205] The present provincial statutory provisions requiring "full" disclosure, which are carried forward into the proposed provincial legislation,[206] deny the commission the flexibility to permit delivery of a terse and simple document in place of the detailed prospectus, unless the terse and simple document contains "full" disclosure.[207] This is particularly unfortunate as the

201 Ontario Securities Regulations, pt. II and forms 13-18.

202 These regulations cover the items suggested in the KIMBER REPORT and in the PORTER REPORT.

203 Ontario Securities Act, s. 41.

204 Lockwood, *supra* note 192.

205 In the United States, the SEC has a rule-making power so the prospectus forms, for example, can be changed at any time. This is also the proposed system in the ALI FEDERAL SECURITIES CODE, Reporter's Revision of Tent. Drafts Nos. 1-3, s. 403. It is difficult to see the advantage of involving the Governor in Council, especially if provisions similar to those in the Administrative Procedure Act were adopted; *see* Baillie, *Securities Regulation in the Seventies*, in 2 STUDIES IN CANADIAN COMPANY LAW, *supra* note 67, at 343, 356.

206 Ontario Bill 98, s. 57.

207 This would perhaps make it impossible to institute a regime of differential disclosure or a summary prospectus such as was recommended in the CANADIAN MUTUAL FUND REPORT and carried forward in the MUTUAL FUND PROPOSALS.

prospectus, even in its current "narrative" form, is hardly a model of readability or of effective communication.[208]

There are three legends or certificates now required to be inserted on every prospectus – the issuer's certificate[209] that the prospectus constitutes full, true and plain disclosure, the underwriter's certificate[210] to the same effect, except that it is restricted by a "knowledge, information and belief" clause, and a legend disclaiming[211] any merit investigation by the securities commissions involved.[212] The substance of these assertions could be made statutory, with the result that the statements themselves could be omitted from each copy of the prospectus. It is difficult to see how the present repetition adds to purposeful disclosure. If it is meant, in the case of certificates, to bring home the statutory obligations to those signing prospectuses then the filing with the commission of one signed certificate should be adequate without the certificate being duplicated on each copy of the prospectus. The prospectus would contain a short statement of the statutory rights available to a purchaser including the liability of the issuer and the underwriter. In the case of the legend, it is often not true because the commission, within its "blue sky" function, does pass on at least some of the merits. The legend is derived from SEC practice where there is no "blue sky" provision. We would recommend that the certificates be omitted in any new statute and that the legend be modified or abandoned.

In addition to filing both the preliminary prospectus and the final prospectus with the commission, the statute requires that a copy of the final prospectus be delivered to each purchaser not later than midnight on the second day after an agreement of purchase and sale is entered into.[213] There is an important exception to this delivery requirement where the prospectus has been delivered to a person "who is acting as agent of or who thereafter commences to act as agent of the purchaser". This exception comes into play on certain primary distributions through the stock exchanges when the broker through whom a purchaser orders securities acts as agent for the purchaser and not as a principal in selling the securities. Thus if the underwriter or issuer on a primary distribution through the stock exchange, or on a best efforts

208 This problem of effective disclosure has been commented upon *supra* and will be a recurring theme in this paper.

209 Ontario Securities Act, s. 52.

210 *Id.* s. 53.

211 National Policy Statement No. 13, April 1971, 2 CCH Can. Sec. L. Rep. ¶ 54-850.

212 It appears from Ontario Bill 98, ss. 59 and 60 that the certificates at least will continue to be required.

213 Ontario Securities Act, s. 64. The statute does not use the term "final" prospectus but it is used in practice to differentiate it from the preliminary prospectus.

underwriting, blankets all members of the stock exchange with prospectuses, the purchasers from brokers who are not directly part of the selling group never need to receive the document.[214] In fact the exception is of limited use to the larger brokerage firms because most of them who act as agents for the purchasers are selling as principals, for business reasons. Only a scattered few brokers, representing a very small minority of the purchasers, are able to use the exemption in any given issue and they would be precluded from participating in the offering if the exception did not exist. Thus, while the exemption seems illogical in theory, we believe that it works in practice and is necessary so long as distributions over the stock exchange are permitted, a point we comment on later.

The preliminary prospectus, commonly called a red herring in the United States because of a useful legend in red type on the front page warning the reader that it is only a preliminary prospectus,[215] might better be called a dead herring in Canada.[216] The purpose of the preliminary prospectus was to permit prospective purchasers to study the merits of the securities to be issued and to permit underwriters to test the market.[217] Thus, during the "waiting period" of at least ten days (which is often longer in practice) between the time when the preliminary prospectus is filed and the time when the final prospectus is accepted the public was to judge the merits of the issue through the ready availability of the preliminary prospectus. However, there is no requirement in the present statutes that the preliminary prospectus be made available to anyone.[218] In fact it receives very limited distribution, partly because of the onerous requirement to keep a record of every person to whom a preliminary prospectus is sent and to send every such person every amendment to the prospectus.[219] Under the proposed new Ontario legislation, any prospective purchaser who asks for one, whether solicited or not, must be sent a copy of the

214 The pre-1967 Act had a similar exemption for cases where delivery was made to an agent of the purchaser, but applicable to all distributions, not only to those made through a stock exchange; *see* Baillie, *supra* note 91, at 180. This peculiar exemption has been carried along in Ontario Bill 98, s. 72(5).

215 The legend was proposed by the Kimber Report ¶ 5.28(c) and is included in the Ontario Securities Act, s. 39.

216 There is no requirement for a preliminary prospectus from Québec eastward or in British Columbia.

217 Kimber Report at 46.

218 Unless a person is sent an advertisement, in which case he must be advised of the address from which a preliminary prospectus is available, or if a prospective purchaser who was solicited by the underwriter indicates an intention to buy.

219 The requirement of keeping a record of the distribution of the preliminary prospectus was criticized by Baillie, *supra* note 91, at 192. This criticism was ignored in 1967 and the same concept is carried forward in Ontario Bill 98, s. 58(2).

preliminary prospectus.[220] One wonders how effective this new provision will be in achieving a wide distribution of the preliminary prospectus[221] to an appreciative audience. If it is effectively disseminated one wonders whether the list of recipients is worth keeping. If the concept of a preliminary prospectus is to be retained more extensive changes in its applications are necessary than those made in the proposed new Ontario legislation. Perhaps the preliminary prospectus could be eliminated or replaced with a signed draft prospectus which becomes part of the public record until the receipt for the final prospectus is received.

As the prospectus is an unwieldy document, it is interesting to note the provisions respecting advertisements and other materials with which the prospective investor may be bombarded. Under the present Ontario statute any printed or written material may be distributed unless prohibited by the regulations. The regulations contain no such prohibition. Under the proposed Ontario legislation this position remains unchanged after receipt of the final prospectus but is reversed during the waiting period.[222] It would seem that some regulations should be considered to limit inappropriate advertising during both periods. Such limitations are better contained in the regulations or rules established under the statute than in the statute itself.[223]

Before leaving the prospectus filing requirements, we wish to comment briefly on the extension of the concept of "distribution" contained in the proposed Ontario statute, which concept replaces "distribution to the public" under the present law. Essentially Ontario Bill 98 would establish a "closed" system in which securities may be sold within a sophisticated group without any prospectus requirements but once they pass out of this group a prospectus

220 Ontario Bill 98, s. 67.

221 It will be recalled that a disclosure provision in the Dominion Companies Act requiring directors to report their trades to the shareholders' meeting, but only if requested by the shareholders, was completely ineffective due to lack of requests; *see* note 90 *supra*.

222 Ontario Securities Act, s. 57; Ontario Bill 98, ss. 66(2), 70. The draft regulations under Ontario Bill 98 had no provisions either, so distribution of anything, except the preliminary prospectus, would be prohibited during the waiting period.

223 It may be worth noting that, in our opinion, the responsibilities of the federal Parliament are now so numerous that it is unrealistic to expect expeditious amendments to statutes other than the Income Tax Act. Accordingly, we tend to favour more regulations or rules but, in so doing, we wish to stress that we think it essential that any proposed changes be widely circulated and adequate time for comments afforded before such regulations or rules become effective. There are many examples of ill conceived rules that might never have been foisted upon the securities industry if proper consideration had preceded promulgation. On the other hand, when advance circulation has been attempted, there is often virtually no feedback from the securities industry. But the industry cannot complain if the opportunity for comment is presented.

must be filed, subject to a number of exemptions. The new provision defines a "distribution" to include:

(1) A trade in securities of an issuer which have not previously been issued. Thus any new issue, whether or not the public is involved and whether or not there is a distribution in the usual sense of that word, must find a specific exemption or be caught by the prospectus requirement unless a relieving order from the commission is obtained under section 75. This considerably widens the ambit of the situations where prospectuses are required and will result in more applications for exemption orders. These applications now consume an inordinate amount of time for the lawyers employed by the commission. To add to this burden may be a heavy price to pay for the gain derived.

(2) A trade by an issuer in previously issued securities which have been redeemed or purchased by or donated to the issuer. This is a logical extension of the primary issue concept in some respects but it will hamper the flexibility of market involvement by the issuer. It seems peculiar that the purchaser of a redeemed preference share should be entitled to a full prospectus whereas he is entitled to nothing if he happens to buy the same share from a director of the issuer.

(3) A trade out of the securities held by a person whose ownership of securities in the corporation materially affects control of the corporation. While this provision is not new, it is still unclear why a substantial shareholder cannot sell some non-voting debt obligations of the issuer which he happens to own, at least in small amounts.

(4) A trade in securities previously issued through an exemption under subsection 73(1) that is not made in compliance with certain other subsections of section 73. This attempts to tighten the "closed" circle to ensure that all securities will have prospectuses filed with respect to them before they can reach the marketplace. But it is peculiar that the requirement for a previously issued security is restricted to subsection 73(1) thereby precluding resale of securities without a prospectus that have been issued through, for example, an exempting order under section 75. This may lead to even more applications than heretofore for section 75 exempting orders on resales.[224]

224 The usual s. 59 order, which is the comparable section in the present Ontario Act, is a "two step" order which requires the purchaser to seek another exempting order on resale. But there are many exceptions to this general rule and the exceptions should increase under the proposed statute, *i.e.* the number of application where a "two step" order would be unnecessary should increase.

We will come back to these concepts from another vantage point when we discuss exemptions.

B. CONTINUOUS DISCLOSURE

While the prospectus has been the most important disclosure document in Canada to date the focus in the disclosure literature since 1966 has been on "continuous disclosure". The basic idea behind this concept is to have available at all times, for public inspection, up-to-date information on all corporations with issued securities that trade in the market. Then the investor, whether on a primary issue or on a secondary market transaction, can obtain reliable information about his prospective investment. In his famous article, *"Truth in Securities" Revisited*,[225] Milton Cohen, who had been the director of the SEC Special Study,[226] suggested that the primary focus in securities regulation should be on continuous disclosure, and that new issue disclosure should be coordinated with such continuous disclosure but should not be free standing in its own right.[227] This remarkable article was followed by the *Wheat Report*[228] of 1969, which also recommended more emphasis on a revised and expanded continuing disclosure system. Since the *Wheat Report*, there have been extensive revisions to the disclosure requirements in the United States. Meanwhile in Canada, a new wave of reports[229] burst forth in the securities area after the 1967 statute was enacted, which reports gave rise to a series of minor statutory changes, major policy changes and major draft legislation in Ontario, which draft legislation is now in its fourth incarnation.[230]

225 Cohen, *"Truth in Securities" Revisited*, 79 HARV. L. REV. 1340 (1966).

226 SEC, *supra* note 115.

227 Cohen attributed the emphasis on primary issues to be a result of the fact that the 1933 Act preceded the 1934 Act. But the 1844 Act preceded both by a fair margin.

228 *See* WHEAT REPORT.

229 These include the REPORT OF THE ROYAL COMMISSION ON ATLANTIC ACCEPTANCE (1969) (Hughes Report); INTERIM REPORT OF THE SELECT COMMITTEE ON COMPANY LAW (1967) (Ontario, Lawrence Report); REPORT OF THE COMMITTEE TO STUDY THE REQUIREMENTS AND SOURCES OF CAPITAL AND THE IMPLICATIONS OF NON-RESIDENT CAPITAL FOR THE CANADIAN SECURITIES INDUSTRY (1970) (Moore Report); OSC, REPORT OF THE SECURITIES INDUSTRY OWNERSHIP COMMITTEE (1972); CANADIAN MUTUAL FUND REPORT (196a); STUDY ON THE SECURITIES INDUSTRY IN QUEBEC (1972) (Bouchard Report); ONTARIO SECURITIES COMMISSION DISCLOSURE REPORT (1970).

230 It started off in 1972 as Ontario Bill 154 which is commented on extensively by Emerson, *supra* note 67. It reappeared in June 1974, after many briefs had been submitted and considered, as Ontario Bill 75. It was introduced again as Ontario Bill 98 in May 1975. It died on the order paper when the 1975 election was called. It was reintroduced in the fall of 1976. It is understood that the Ontario Bill has been discussed with administrators in each province. One might logically predict a uniform statute, but logic is not grist for the securities regulation mill.

Essentially the 1966 Ontario statute brought in an expanded form of continuing disclosure requirements: periodic financial reporting; mandatory proxy solicitation with accompanying information circulars; monthly reporting by insiders of trades in the securities of issuers and requirements relating to the content and dissemination of takeover bid offers.[231] The thrust of the statute was really directed at filling the long-standing gap in the application of disclosure policy between the new issue market and the trading market.[232] But the 1966 Act only included in its ambit for continuous disclosure, issuers which were traded on the Toronto Stock Exchange or which had filed a prospectus relating to equity securities with the Ontario Securities Commission after May 1, 1967.[233] This evidently left out several important enterprises, a problem which would be partly remedied under Ontario Bill 98.

The major pieces of continuing corporate disclosure under the 1966 Act were the financial reports and the information circulars, both of which had to be sent to shareholders but only the financial reports had to be filed with the commission. Accordingly there was a gap on the commission's records if a single repository of all corporate information regarding a given corporation was the goal.[234] Since 1970 the commission records have been even less complete for not all "timely disclosure" announcements need be filed there. The policy of timely disclosure[235] does however amount to a continuing disclosure of important events in the ongoing saga of a business enterprise which is not restricted just to companies that have filed prospectuses or are posted for trading on a stock exchange.

Under Ontario Bill 98, a new concept is introduced, namely, a "reporting issuer". This defined term includes any enterprise whose securities are or have been posted for trading on the Toronto Stock Exchange; any enterprise which is an Ontario corporation that is offering its securities to the public; any enterprise which

231 For further details, *see* Creber, *Take-over Bids, Insider Trading and Proxy Requirements*, LAW SOCIETY OF UPPER CANADA, SPECIAL LECTURES: DEVELOPMENTS IN COMPANY LAW 235 (1968); Bray, *Financial Disclosure and Accounting Practice*, *id.* at 251.

232 Emerson, *supra* note 67.

233 Ontario Securities Act, s. 118. Even then, banks were excluded.

234 That gap was not very important in the usual case as there is very little information in the information circular. It is important, however, when major corporate changes are being considered.

235 Uniform Act Policy 2-12, December 6, 1971, 2 CCH CAN. SEC. L. REP. ¶ 54-882. It should be noted that there are "National Policy Statements" which apply in eight of the ten provinces (Nova Scotia and Newfoundland remaining aloof), there are "Uniform Act Policies" for Ontario westward, and there are just plain Policy Statements on a province-by-province basis. There is much more unwritten policy than written policy.

has filed a prospectus with the OSC after Bill 98 becomes law, and any enterprise which had filed an equity share prospectus with the OSC since May 1, 1967.[236] Every reporting issuer is required to issue and file with the commission a press release disclosing forthwith the nature of any material change.[237] In addition the reporting issuer must file all information circulars and both annual and semi-annual financial statements with the commission.[238] The hope was that there would be a central repository where there would become available, in readily identifiable and accessible form, substantially the equivalent of a current prospectus of every reporting issuer.[239] This will take an enormous amount of time to accomplish or never occur because there are no requirements in Ontario Bill 98 that an initial overall disclosure be made or that compilation of the various bits of information be undertaken periodically. It might also be noted that, as the annual audited financial statements can be 140 days[240] stale when filed and the interim unaudited statements can be sixty days old, the information is far from current.

So far as corporate disclosure is concerned, the new proposed Ontario system is really the old system with a few new labels. The system in the *ALI Federal Securities Code* proposed in the United States is much more extensive. There the threshold is 300 holders of securities together with $1 million of total assets. Once past that threshold every enterprise must register as an issuer with the SEC. This amounts to filing the same documentation as would be filed on a distribution of securities to the public.[241] Once registered a registrant must file, send to security holders, keep a record of and publish whatever reports the commission requires "to keep reasonably current the information and documentation contained in the registration or to keep investors reasonably informed with respect to the registrant".[242] The status of a registered issuer may be terminated once the number of holders of all its securities drops below one hundred.[243]

236 Ontario Bill 98, s. 1(1)35. Under s. 84, a reporting issuer whose shareholders have dwindled to less than 15 can apply to be "deemed to have ceased to be a reporting issuer".

237 Ontario Bill 98, s. 76(1); there are secrecy provisions if the information may be detrimental to the interests of the reporting issuer.

238 Ontario Bill 98, ss. 78(1), 79(1), 82(1).

239 Cohen, *supra* note 225, at 1406. Ontario changed "continuous registrant" to "reporting issuer".

240 It is not clear why the auditors in Canada are so slow; the SEC only allows 90 days.

241 ALI Federal Securities Code, Tent. Draft No. 1, s. 403, provides that "a registration statement shall contain whatever information, financial statements, material contracts and other documents the commission specifies by rule".

242 *Id.* s. 601.

243 *Id.* s. 405.

The *Ontario Securities Commission Disclosure Report* would have adopted a similar system for Ontario and such a system was proposed in Ontario Bill 154.[244] But apparently the reactions in the briefs submitted[245] convinced the provincial authorities to modify the system. The result is an unsatisfactory hodgepodge for companies that are not required to file an initial document before becoming a reporting issuer. Even more importantly, the concept of permitting an issuer, who was a reporting issuer, to use an offering circular rather than a full-blown prospectus on any new issue has been abandoned.[246]

C. EXEMPTIONS FROM PROSPECTUS REQUIREMENTS

Under any system which utilizes the prospectus as the basic disclosure document, it becomes most important to know when that document must be used. If the focus is on investor protection with respect to the securities then to be issued, there are many exemptions which are reasonable. If the system includes adequate continuous disclosure requirements, many more exemptions could be tolerated or at least the requirements for the offering circular made less onerous for companies that are "continuously disclosing". By imposing the full prospectus provision the existing provincial law requires a complicated set of exemptions.[247] The legislature has recognized two separate categories of appropriate exceptions, those where the security is of such a nature as to be beyond reproach and those where the potential investor is thought capable of protecting himself. In addition, there is the very important category of trades which are not a "distribution to the public", which is an exclusion by definition rather than through an exemption.

This concept of the "public" in one way or another has been essential to a system relying on a prospectus. It is recognized that there is no utility in forcing a private company with only family shareholders to prepare mammoth disclosure documents. The information requirement becomes important when potential investors without information are approached with a view to soliciting

244 *See* Emerson, *supra* note 67, at 439.

245 There were numerous briefs submitted and most commented on the "cornerstone prospectus" idea, which was Ontario's suggestion for an initial document. The draft regulations setting out the contents of this document were poorly drafted and ill-considered. The result was that most briefs suggested amendments of one form or another.

246 This again is part of the proposed ALI Federal Securities Code, Reporter's Revision of Tent. Drafts Nos. 1-3, s. 501.

247 The best writing in this area is Dey, *Exemptions under the Securities Act*, in Law Society of Upper Canada, *supra* note 192, at 127.

their capital. The appeal for capital from outsiders should be the trigger for significant disclosure. On the other hand, under an issuer registration system the concept of "public" is really replaced by a threshold. Thus under the proposed system in the United States, if the company does not have 300 security holders, it need not become a registered issuer. Once the arbitrary level has been reached, reporting is required regardless of the amount of securities-related activity of the issuer, until the issuer is deregistered.

The basic trigger for prospectus requirements and therefore disclosure requirements under the Ontario statute is the concept of a "distribution to the public". On one end of the spectrum of possibilities one could say that a "public" distribution only arises if there is a general invitation to all members of a community.[248] On the other end one could say that a distribution arises every time one newcomer is approached, if the issuer would approach another newcomer if the first approach were unsuccessful.[249] The more difficult cases arise when a particular class, such as the security holders, are singled out for special attention that will not be accorded others.[250] In such a case it is not clear that the public is involved, regardless of the extent to which the investor may be uninformed. To date the Canadian cases indicate that there must be an offer generally and not just to friends or associates or persons having common bonds of interest or association. But the numbers do not matter much once it is a general offer past such a delineable group.[251]

The position in the United States is quite different perhaps in part due to the difference in the exempting sections. There is a specific exemption for "transactions by an issuer not involving any public offering". But there are not the myriads of other little exemptions found in the Canadian legislation. In the important *Ralston Purina*[252] case, the court articulated a "need to know" standard which has been quoted ever since. In that case the

248 This was the view taken by the U.K. courts in Shorto v. Colwill, 26 T.L.R. 55 (Ch. 1909); Sleigh v. Glasgow and Transvaal Options, 6 Sess. Cas. (5th ser.) 120 (H.L. 1904); *but see* R. v. Piepgrass, 29 W.W.R. 218 (Alta. C.A. 1959) (*per* MacDonald, J.A.).

249 This is a view sometimes ascribed by authors to Viscount Sumner as a result of the decision in Nash v. Lynde, [1929] A.C. 158 (H.L.); *see* Dey, *supra* note 247, at 135. In fact, the situation in Nash involved several people so the remark is *obiter* at best. When read in context it makes sense. Lord Sumner is talking of approaching complete strangers, telling them the prearranged story and then collecting the money. If this occurs, then the offer is to the public even if the first gullible prospect takes up the whole offer. But there must have been a number of prospects in view.

250 *See* Government Securities Ltd. v. Christopher, [1956] 1 All E.R. 490 (Ch.).

251 *See* R. v. Piepgrass, *supra* note 248; R. v. Empire Dock Ltd., 55 B.C.R. 34 (Cty. Ct. 1948); R. v. McKillop, [1972] 1 O.R. 164 (Prov'l Ct.).

252 346 U.S. 119 (1953).

offering was to employees of the issuer but since there was a "chow loader" amongst the offerees, who had a "need to know", the public offering exception was denied. The *Ontario Securities Commission Disclosure Report* suggested that the "need to know" test should be adopted in Canada,[253] and the method proposed to accomplish the purpose was to eliminate the concept of the "public" entirely.[254] Then a more direct focus could be made in the exemptions on the concept of the necessary knowledge of the investors. A discretion in the commission to grant an exemption on the basis that the prospective purchaser did not need prospectus disclosure or that the trades would not be against the public interest, rounded out the picture. The theory is both simple and appealing so long as the exempting rules can be drawn sufficiently wide that the residual discretion in the commission is seldom necessary. If, however, the exemptions are not wide enough a prodigious amount of unnecessary adjudicative procedure will result. If the exemptions are too wide they will cover cases for which exemption is inappropriate.

Before examining the exemptions under the proposed provincial legislation, we will first look at the specific exemptions provided under the current legislation which complete the picture of when a prospectus is or is not now required. As we noted earlier, there are two genera of exemptions, one related to the type of transaction involved and one related to the type of security involved. It is easiest to deal first with exemptions based on types of securities as the issues are somewhat less complicated. These securities exemptions subdivide into exemptions based on the status of the issuer and exemptions based on the security being issued. The important exemptions based on issuer status are:

(1) Any debt obligation of or guaranteed by a government of any country or any political division thereof.[255] This is much wider than the corresponding exemption in the United States which requires the equivalent of a prospectus for foreign government issues.[256] It is difficult to see why no protection is afforded Canadian investors on foreign issues and we recommend that the exemption be narrowed accordingly.

(2) Any debt obligation of municipal corporations in Canada.[257] While historically municipal bonds have not always been attractive, it is likely the case today that intervention by a

253 *See* Ontario Securities Commission Disclosure Report ¶ 1.26.

254 *Id.* ¶ 3.15.

255 Ontario Securities Act, s. 19(2)1(a).

256 *See e.g.* ALI Federal Securities Code, Reporter's Revision of Tent. Drafts Nos. 1-3, pt. III.

257 Ontario Securities Act, s. 19(2)1(b).

senior level of government would save the bondholders. It is doubtful if any change in this exemption would be feasible politically even if it were necessary for investor protection, which we doubt.

(3) Any debt obligation of a Canadian bank, loan company or trust company.[258] It is not at all clear why an investor in debt obligations of the major financial intermediaries is in any lesser need of protection than his confrere who invests in bonds of other large industrial companies. On the other hand, the financial intermediaries are already regulated directly. If such regulation ensured adequate investor information there would be no need for duplication under a securities regulation statute. To our knowledge no such investor information is required at all, not even to the extent of telling a prospective purchaser of subordinated debt the amount of existing debt load ahead of him. This seems regrettable. The same principle applies with respect to guaranteed investment certificates of trust companies, which are also exempt under the current statute.[259]

(4) Securities issued by charitable, fraternal or recreational organizations where no part of the net earnings enure to the benefit of the security holders.[260]

(5) Securities issued by cooperatives.[261]

(6) Shares of a credit union.[262]

(7) Securities of a private company issued by the company if the

258 *Id.* s. 19(2)1(c). The International Bank for Reconstruction and Development is included under s. 19(2)1(d) if the debt is payable in U.S. or Canadian currency. This rider of currency of payment appears very narrow.

259 Ontario Securities Act, s 19(2)2. Under Ontario Bill 98, there is an exemption for variable insurance contracts which guarantee that at least three-quarters of the premiums paid to the date of termination will be returned. This is simply an affirmation in the statute of what the present policy is. It is our understanding that the insurance companies do not show any reserve to cover this three-quarters premium liability – it is so low as to be irrelevant. Thus, the securities commissions, after some hesitation, have decided not to require disclosure with respect to variable insurance contracts; *see* Re Variable Equity Insurance Contracts, [1969] OSC Bull. 179 (November) and [1970] OSC Bull. 128 (September).

260 Ontario Securities Act, s. 19(2)6. This exemption is important for golf clubs and social clubs. Usually charities do not have any securities outstanding. We know of no problems which have arisen as a result of this exemption.

261 Ontario Securities Act, s. 19(2)7. A relatively new statute in Ontario, the Co-operative Corporations Act, S.O. 1973, c. 101, provides in s. 34 that before the issue of any securities by the cooperative, an offering statement must be filed with the Minister and a receipt obtained. The standard of disclosure in s. 35 is "full, true and plain disclosure of all material facts relating to the securities proposed to be issued". This is an example of an industry which is being directly regulated and it is therefore appropriate that it be excluded from substantially identical requirements under the Securities Act.

262 Ontario Securities Act, s. 19(2)8. Again there is special legislation under The Credit Union Act, R.S.O. 1970, c. 96 dealing with these institutions.

securities are not offered for sale to the public. This exemption depends on the definition of "private company", which definition provides that the instrument of incorporation must (a) restrict the right to transfer shares, (b) limit the number of shareholders to fifty persons and (c) prohibit any invitation to the public to subscribe for its securities. It is presumably because only the instrument of incorporation must prohibit the public sale under the definition that the exemption repeats this prohibition on a factual basis. The reason for the exemption is apparent: one does not wish to have family businesses or close corporations clogging the administrative apparatus or wasting time with unnecessary disclosure. Yet the concept of a "private company" is being abandoned in "modern" Canadian corporate statutes.[263] The attempt to preserve for securities regulation purposes what is becoming an endangered species in the corporate world, highlights the difficulty inherent in the concept that required disclosure is appropriate only where public investors are involved. In the *Mutual Fund Proposals* we recommended that the statute not apply to a mutual fund of which the issued securities are beneficially owned by fewer than fifty persons.[264] We believe this is an acceptable posture for securities regulation generally. Thus so long as the total number of beneficial owners of securities of the entity stays at less than fifty, no prospectus-type disclosure need be made.[265]

(8) Finally there are three exemptions for initial mining development work. One is the sale of securities by a prospector to finance a prospecting expedition. The second is the sale by a prospector or the syndicate of securities of a prospecting syndicate where the syndicate agreement has been filed under the act.[266] The third is securities issued by mining companies in exchange for mining claims.[267] As all these arrangements relate to a particular industry it would seem sensible to treat them outside of the main stream of securities regulation. To the extent they would not be covered by some minimum number of security holders rule, as suggested

263 *See* Canada Business Corporations Act; Ontario Business Corporations Act.

264 2 Mutual Fund Proposals, s. 2.01(2)(b).

265 We would note that this posture would make it unnecessary to have a separate exemption for prospecting syndicates or for investment clubs as proposed in Ontario Bill 98, ss. 35(2)5, 35(2)13. Obviously, the question of whether 25, 50 or 100 is an appropriate number is an open one.

266 Section 34 of the Ontario act relates to the terms and filing provisions of syndicate agreements. The exemption only applies if the director issues a receipt for the syndicate agreement.

267 These three exemptions are in ss. 19(2)10, 11, 12, 12a.

above, then direct regulation would seem appropriate if any separate exemption is to be provided.

Each of these eight categories of exemptions for securities based on issuer considerations is carried forward into the proposed Ontario legislation[268] together with additional exemptions for investment clubs and for securities issued by trust companies in respect of pooled accounts or accounts maintained to service registered retirement savings plans. The retirement plan exemption fits into the general category of securities regulated more directly under other legislation[269] while the investment club, being limited to fifty shareholders, is within the "private" principle we have previously suggested. Thus there are really four categories of exemptions based on the securities issuer:

(1) securities issued by governments (which we would restrict to Canadian governments);
(2) securities issued by private institutions;
(3) securities issued by not-for-profit organizations;
(4) securities issued by issuers regulated under other statutes.[270]

The security exemptions based on the type of security form a much shorter but equally important list. There are really only three of these, namely, "short-term" paper in denominations of $50,000 or above, mortgages sold by a person registered under the Mortgage Brokers Act and securities evidencing debts due under conditional sales contracts if such securities are not offered for sale to the public.[271] All of these exemptions are carried forward into Ontario Bill 98 and all seem to be appropriate considering the practical restrictions which we believe to exist in the marketplace for such securities. It does seem strange in the short-term exemption to place a $50,000 limit and a twelve-month term limit in the

268 For some reason which is not immediately apparent the exemption for securities issued for mining claims is deleted. This seems strange as the exemption only applies if there is an acceptable escrow agreement. This escrow agreement should be able to deal effectively with the secondary market problems.

269 In this case, by the Ontario Pension Benefits Act, R.S.O. 1970, c. 342.

270 In the ALI Federal Securities Code, Reporter's Revision of Tent. Drafts Nos. 1-3, at 43-46, the Reporter makes mention of various plans introduced under the Internal Revenue Code. The Reporter points out that these plans vary from time to time and are more appropriately covered by exempting regulations or rules than by direct statutory exemption. The same comment appears apposite in Canada where Registered Home Ownership Savings Plans are the latest but unlikely to be the last in a series of tax relief schemes. Viewed in this light, the reference to Registered Retirement Savings Plans in Ontario Bill 98 is unfortunate.

271 These exemptions are found in Ontario Securities Act, s. 19(2)4, 5, 6. The inclusion of the phrase "not offered for sale to the public" is redundant with the s. 35 concept of only requiring a prospectus if there is a public distribution. But the exemption would be important if the concept of "to the public" were abandoned. Thus, the exemption is continued in Ontario Bill 98 although it is there restricted to sales to persons other than individuals under s. 35(2)8.

statute itself. Both limits could be included in the regulations so variations could be introduced without the necessity of statutory amendment. While there is a general clause to allow any type of security to be exempted by regulation, only two exemptions have in fact been introduced by regulation.[272] We assume that a regulatory power granted at the federal level would be exercised more frequently.

Of equal significance to the securities exemptions are the trading exemptions.[273] By far the most important of these exemptions are:

(1) a trade where the purchaser is a bank, trust company, insurance company or other person recognized by the commission as an exempt purchaser (there is a long list of these, particularly pension funds) if the purchaser purchases as principal for investment only and not with a view to resale;[274]

(2) a trade where the purchaser is a person, other than an individual, or company who purchases for investment only and not with a view to resale, where the aggregate acquisition cost to such purchaser is not less than $97,000.[275]

Both these exemptions require an investment intent and the only real difference is that there is no minimum figure for institutional purchasers. This is important for trust companies who purchase for accounts fully managed by them where the purchases are often less than $97,000. These purchases, while really not by the trust company as principal are treated as such under the statute.[276] These two exemptions together with the general inap-

272 These are the regulations relating to the conversion of convertible securities pursuant to a right contained in them and the regulations relating to puts and calls written by others. The convertible securities regulations were likely unnecessary but their existence now causes problems as it suggests that the conversion of one security is the trading of another security.

273 We will not treat as an exemption for disclosure purposes the provisions for primary distributions over the stock exchange where a statement of material facts is required; *see* Ontario Securities Act, s. 58(2)(b). In practice, the statement of material facts has become almost the same as a prospectus and the problem is one of dissemination of disclosed information rather than an exemption from disclosure.

274 Ontario Securities Act, ss. 58(1)(a), 19(1)3. The vendor is required to file a Form 11 certified by the purchaser at the time of sale; *see* Ontario Securities Regulations, s. 11(1). The purchaser is required to file a form 12 at the time of resale. In this way, the Commission could check what resales do in fact take place. It is not known what action, if any, has been taken as a result of institutions filing forms 11 and 12 where it appears that securities have been resold in such a way to question that the requirement of investment intent has been met.

275 Ontario Securities Act, ss. 58(1)(b), 19(3). The comments in note 274 *supra* apply to this exemption as well. *See* Dey, *supra* note 247, at 144.

276 Ontario Securities Act, s. 58(1a). For years, the trust companies simply gave a total figure on "private placements" and broke the accounts out later. This subsection, introduced in 1971, merely legitimated what was common practice anyway.

plicability of section 35 to anything that is not a distribution to the public, form the base for the "private placement" exemption. A "private placement" is the most important new issue exemption and we will deal with it much more fully in our suggestions for new Canadian approaches.

There is a pair of trading exemptions where dealers are purchasing for their own account, whether as an underwriter or not.[277] These two exemptions are based on the realities of the structure of the issuing markets in Canada plus an appreciation of the sophistication of the brokerage houses.

Another important set of exemptions is the exemptions based on a "no-sale" theory.[278] Pursuant to that concept the exchange of securities by existing securityholders is not like a new issue but is like a replacement. Thus securities received pursuant to a statutory amalgamation or other like procedure[279] or pursuant to a takeover bid[280] are exempt from prospectus requirements. A short extension of this principle brings in trades to promoters of the issuer,[281] trades to employees,[282] issuance of rights[283] and stock dividends[284] to existing securityholders. The only other trading exemptions are for the purchase by way of private agreement with fewer than fifteen shareholders and for an exchange of assets in excess of $100,000 where the securities are acquired with investment intent. These last two exemptions are really little loophole fillers in the private placement area rather than extensions of the no-sale theory.

The above list of trading exemptions deals with situations where there would be a first "distribution to the public" of the securities involved. Similar exemptions on primary distributions exist under the proposed Ontario legislation. But we must not forget secondary distributions or secondary trading. It will be recalled that under the definition of "distribution to the public" there is included the concept of a "secondary-primary" when a person in a position to materially affect control sells securities. Yet there is an acknowledged need to let the insider sell some securi-

277 Ontario Securities Act, ss. 58(1)(d), (e) coupled with s. 19(1)6.

278 *See* 1 L. Loss at 518.

279 *See* the Ontario Securities Act, ss. 19(1) 9, 19(1)8(ii).

280 *See id.* s. 19(1)9(c). Of course, there is a requirement for substantially similar disclosure through the takeover bid circular; *see id.* s. 91.

281 *Id.* s. 19(1)9(c).

282 *Id.* s. 19(1)10. Note this exemption reverses the *Ralston* result discussed *supra*, so far as the facts of that case as opposed to the principle in it are concerned.

283 Ontario Securities Act, s. 19(1)8(iii). Rights issues require some minimal documentation to be filed with the commission.

284 *Id.* s. 19(1)8(i).

ties at some time, which necessitates a "fur coat" exemption.[285] With this in mind an isolated trade exception, when the securities are sold across the stock exchange, is specifically provided.[286] Unfortunately the present exemption does not limit the size of the isolated transaction with the result that several public distributions have been effected through this exemption by first using the isolated purchaser exemption to sell to a friendly institution which can then unload to the public without worrying about any requirements of "investment intent".

Of course ordinary secondary transactions do not need to depend on a specific exemption if section 35 is not applicable in any event, that is, if there is no "distribution to the public". Before 1971 the applicability of section 35 was limited to "primary distribution to the public" which was defined to include distributions to the public of "securities issued by a company and not previously distributed". In 1971 this definition was changed to "clarify the meaning"[287] by adding on the words "to the public" at the end so that the definition now read "securities issued by a company and not previously distributed to the public". These additional words have caused some confusion. Take, for example, the not uncommon situation of a private placement to ten exempt institutions. Would the resale by such institutions trigger prospectus requirements? Before 1971 many lawyers argued that the securities in question had been "previously distributed". But it is more difficult to say that the securities have been "previously distributed to the public". The commission takes the view that the resale is exempt on the ground that any sale to any institution is a sale to the public or one would not need the exemption in the first place. But this is a tortured interpretation of the statute.[288] Accordingly the question of required disclosure on secondary trading is very difficult in many cases. It is fair to say that in practice, there is little or no prospectus type disclosure on the resale of securities initially issued as a private placement.

The proposed Ontario system is completely different in its approach to secondary trading exemptions. Borrowing heavily from the United States but still lacking the concept of registered securities, the proposed statute attempts to create a wall around private placements in such a way that the first escape triggers

285 *See* Dey, *supra* note 247, at 172.

286 Ontario Securities Act, s. 58(2)(c). One can always apply under s. 59 for a commission order and these are fairly common in this situation; *see* OSC Policy No. 3-18, June 14, 1973 *as amended*, 2 CCH Can. Sec. L. Rep. ¶ 54-912, at pt. III.

287 Ontario Securities Commission Disclosure Report at 45.

288 *See* Baillie, *supra* note 205; *see also* Dey, *supra* note 247, at 142-44; Meech, *Prospectus*

prospectus requirements unless the issuer becomes a reporting issuer. Subsection 54(2) contemplates that any issuer can become a reporting issuer at any time by filing a prospectus and preliminary prospectus. Thus where the initial placement is with an exempt institution, any resale of that security would constitute a distribution unless:

(1) the original issuer becomes a reporting issuer and was not in default of any requirement of the act;[289]
(2) no unusual effort is made to condition the market;
(3) a report is filed within ten days with the commission;
(4) the securities have been held by the initial purchaser for at least six months and in some cases up to eighteen months[290] before resale.

The proposed bill also introduces an important new category of trades which are treated as private placements, namely: trades where not more than twenty-five purchasers are involved,[291] the purchasers are seeking the securities themselves rather than being sought after and each purchaser either is an experienced investor, has an experienced investor acting for him or has access to detailed information respecting the issuer.[292] A resale by the sophisticated purchaser without a prospectus is predicated on the same set of criteria described above for the standard form of private placement.

The other exemptions proposed in Bill 98 are essentially the same as those under the current legislation with minor changes which could be amended before passage. Accordingly we do not elaborate on them in detail at this juncture. One change has been to move "puts" and "calls" into an exempt category in the statute itself.[293] This may prove to be somewhat premature as we would be inclined to the view that the system of the option market is still in a state of flux.[294]

Before leaving the current set of disclosure requirements

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and Registration Requirements, in LAW SOCIETY OF UPPER CANADA, *supra* note 231, at 211, 224.

289 Ontario Bill 98, s. 73(4)(a). How the vendor will know whether the issuer is up-to-date is clarified, *id.* s. 133 coupled with ss. 73(8), (10).

290 The 18-month holding period is for unlisted securities that do not fit within the "legal for life" categories.

291 There can be as many as 50 offerees.

292 The concept is very similar to the concept of a "limited offering" under ALI FEDERAL SECURITIES CODE, Reporter's Revision of Tent. Drafts Nos. 1–3, s. 227(b).

293 It was recently added as an exempt category in Ontario Securities Regulations, s. 86.

294 An option exchange has been operating in Chicago for some time now and it has revolutionized the "puts and calls" system in that country. Such a change may well occur in Canada as well.

triggered by the issue of additional securities into the hands of the public, we believe we should refer somewhat more specifically to the distributions carried out on the Toronto Stock Exchange. These distributions require a Statement of Material Facts to be filed which complies with the regulations and forms under the Securities Act. While this document is very similar to a prospectus it tends to be somewhat easier to prepare, is processed confidentially by the commission[295] and carries no requirement of a waiting period or preliminary prospectus. There are essentially two types[296] of offerings now permitted, the first of which is fixed price pre-market offerings. In these offerings a book is maintained on the exchange floor from 9:00 to 9:30 a.m. by the offeror's agent. Up to 25% of the offered securities, in the discretion of the stock exchange, must be publicly available but the rest can be reserved for clients of the member doing the offering.[297] This type of offering can be used for distributions of control block stock and a similar procedure has been used (under a different exemption) in some takeover bid situations. Obviously it has the appearance of undue haste and its continued existence is under attack. The other type of exchange offering is an open market distribution pursuant to which shares are sold by the issuer at the prevailing market price from time to time during normal trading hours.[298]

Finally we must allude to other disclosures required under the securities acts which we have virtually ignored as they are more fully discussed elsewhere. Within this group comes insider trading reporting, takeover bid circulars, directors' circulars and proxy forms. Each of these has important elements of disclosure within it but each can be logically severed from the general discussion of an appropriate federal regulatory pattern.

Chapter VI
Appropriate Canadian Federal Regulatory Pattern

A. ASSUMPTIONS AND OBJECTIVES

Having briefly reviewed the current situation in the Canadian provinces and the reasons that support a disclosure system as an integral part of securities regulation, we now wish to set forth our

295 *See* Apple, *Financing through the Toronto Stock Exchange*, in LAW SOCIETY OF UPPER CANADA, *supra* note 192, at 225, 232.
296 *See* Dey, *supra* note 247, at 172.
297 *See* Apple, *supra* note 295, at 240-41.
298 *Id.* at 249. *See* Statement of Policy Regarding Primary Distribution through the Facilities of the Toronto Stock Exchange under the Provisions of the Securities Act.

suggestions for the disclosure requirements which we believe would be appropriate in a Canada Securities Act. As our instructions require, in formulating these suggestions we have been cognizant of the existing Canadian legislative pattern but we have deviated from that pattern where we believe it can be improved. We stress, however, that none of the proposed changes is of sufficient importance to justify its implementation by the federal government while the provincial statutes remain in force in their present terms. If a federal decision to enter the area of securities regulation results in the creation of another layer of regulation, the resultant inconvenience will be vastly increased if the additional layer of regulation is inconsistent with, or even significantly different from, the existing requirements of the provincial governments.

Disclosure requirements of securities regulation cannot be formulated independently of other aspects of the regulatory pattern. We have therefore found it necessary to make a number of assumptions as to the context in which our proposals would be reflected. The following list of assumptions conforms in most respects with existing provincial requirements and therefore does not imply any conclusion as to the appropriate ambit of federal requirements. Our proposals would, we believe, be workable in a regulatory milieu which is consistent with the assumptions, regardless of the allocation between provincial and federal responsibility in that milieu.

The following are our assumptions as to the regulatory milieu in which our proposals would be reflected:

(1) That any remedies provided in the statute for investor protection will not be dependent on the investor receiving or reading any required document except, in the case of some remedies, in a negative sense. For example, if a prospectus is required at the time of initial issue, then the investor will be deemed, as under present law, to have relied on it whether or not he read it. On the other hand, non-receipt of a required document may entitle the investor to a continuing right of rescission.

(2) That brokers will continue to be licensed, their qualifications will be kept under continuing review to ensure their adequacy and the present rules, such as the "know-your-client" rules, will continue to apply.

(3) That all stock exchanges in Canada will continue to be self-regulatory bodies but will be subject to regulation by the

Canada Securities Commission[299] which regulation could extend to imposing positive duties on the exchanges.

(4) That other self-regulatory bodies, such as the Investment Dealers Association of Canada, will be subject to commission regulation that could include the imposition of positive obligations.

(5) That debt securities will not become generally listed or posted for trading on the stock exchanges or on any other centralized facility but that stock exchanges or another central facility will continue to provide the principal (or even the exclusive) secondary market for equity securities. Further, individuals will continue to be significant direct holders of equity securities, not being altogether replaced by financial intermediaries, and will have access through their brokers to the secondary trading market.

(6) That the commission will have a very wide rule-making power,[300] will be adequately staffed both quantitatively and qualitatively[301] and will be established as an expert body whose independence will be respected by the government within reasonable limits.

(7) Financial intermediaries, including banks, insurance companies, trust companies and mutual funds will be subject to more direct forms of regulation. Accordingly, no specific disclosure provisions tailored to such institutions need be made in our proposed legislation.

In addition to the above assumptions we have also assumed that there are no constitutional limitations which would restrict the federal government in demanding disclosure from any commer-

299 Throughout the paper, we speak of a Canada Securities Commission as though it were an existing fact. We realize that legislation without a commission at all would be possible. We only use the "commission" as a shorthand to represent the responsible regulatory authority, whether federal or provincial.

300 As Professor Loss said in his remarks to the American Law Institute when he introduced the Federal Securities Code Project:

> "Whatever we do, we certainly cannot diminish overall the Commission's rule-making power. One cannot live in this field without a great deal of administrative rule-making power."

Loss, *The American Law Institute's Federal Securities Code Project*, 25 Bus. Law. 27, 32 (1969). The rule-making authority should not however extend to substantive regulatory power over segments of the industry as is now the case with respect to mutual funds and real estate investment trusts.

301 We do not wish to be misinterpreted as saying that the provincial commissions are not now adequately staffed when such a statement has not been documented. We wish to recall the opinion to this effect in the Porter Report, and to add a caution based on our own experience with other federal regulatory agencies. The traditions of excellence reputed to exist in the civil service in both the United Kingdom and Australia and the high esteem in which the staff of the SEC is held in the United

cial enterprise, regardless of where it is incorporated or where it does business, if the enterprise wishes to avail itself of any of the facilities of the Canadian capital markets.[302]

While we have endeavoured in the formulation of the suggestions to maintain neutrality as to the allocation of responsibility between the federal and provincial governments, we have not found it desirable altogether to ignore this important question. We feel that the federal system should be sufficiently complete in itself that any province, if it so desires, could opt out of the securities regulation field entirely and still be satisfied that investors within the province were reasonably protected. As a corollary of this position it seems to us essential to have a "blue sky" provision in the federal statute, since the provinces have come to assume and accept the desirability of such a provision and since there are strong arguments for the availability of some review provision that goes beyond disclosure. Further, we have attempted to shape our suggestions so that a province could retain an independent "blue sky" discretion while relying on Ottawa to exercise the bulk of responsibilities for securities regulation.[303]

As the assumptions indicate, we do not envisage radical changes in the system of securities regulation that has developed through experience. Earlier in this report we refer to the school of thought which decries the disclosure system as useless and economically wasteful[303a] and indicate our belief that disclosure requirements have a valid public policy purpose and that without them government would be likely to extend its degree of direct involvement in economic regulation. Accordingly, we would retain the broad concepts of present disclosure law, with information being available both to primary and secondary market investors. Disclosure of an initial issue will remain more detailed however in view of the probable lack of prior knowledge concerning the

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States must be duplicated in the government agency in Canada given responsibility for the Canada Securities Act.

302 The constitutional questions are discussed in depth in *Anisman & Hogg*.

303 Loss, addressing himself to the same question in the United States said:

> "[P]erhaps we could leave the states to deal with the small, promotional offerings, the initial public offerings, and tell them to stop bothering, as many of them have stopped anyway, with A.T. & T. and General Motors and a lot in between. The state offices, by and large, are undermanned anyway, and if their attention could be devoted to the regulation of local offerings and local brokers and dealers and local fraud situations we might have much more effective overall protection than we do today, when there is a lot of unnecessary duplication at the federal and state level."

ALI Federal Securities Code, Tent. Draft No. 1, at xxxix. In Canada, if some provinces are to be permitted to opt out while some stay in, cooperation is even more important.

303a *See* articles cited in note 117 *supra*.

issuer and its securities within the industry generally. Periodic reporting both to shareholders and to the public generally will occur at least semi-annually. Special disclosure requirements for takeover bids and for insider trading will continue to be necessary. In addition, disclosure requirements for information that is not investor-oriented, will increase.

B. CONTINUOUS DISCLOSURE

1. *Reporting Issuers - Definitions*

In the *ALI Federal Securities Code*, in the 1974 Corporations and Securities Industry Act which was proposed in Australia and in the proposed Canadian provincial legislation, a continuous disclosure requirement is imposed on certain businesses. In the United States the mandatory trigger for continuous disclosure for an enterprise occurs where there are over 300 holders of its securities and its gross assets exceed $1 million.[304] Under the Australian draft legislation, every public company, which is defined to mean every company that is not a proprietary company, must report. Under the proposed Ontario legislation, every issuer that is listed on a stock exchange or that files a prospectus under the statute must become a "reporting issuer".[305] A reporting issuer in Ontario and a registrant in the United States must report and publish all material changes, substantially as they occur.[306] It seems evident that the legislative trend, which we support, is for widely-held companies to report regularly to the public and to maintain an up-to-date file with a central depository, namely the commission. The commission should be given the widest possible latitude to specify in published rules the types of reports required. We support also the Australian system that any disclosure filed with the commission should be automatically filed with all recognized stock exchanges. Requirements to this effect should be adopted in Canada when the exchanges have developed a system for communicating such information to exchange members, which system the exchanges should be encouraged to develop as quickly as possible. Conversely we believe that all documentation filed with the stock

304 Under ALI FEDERAL SECURITIES CODE, Reporter's Revision of Tent. Drafts Nos. 1-3, s. 401, the issuer then must file a registration statement, after which it becomes a "registrant".

305 Defined in Ontario Bill 98, s. 1(1)35.

306 Ontario Bill 98, s. 76; ALI FEDERAL SECURITIES CODE, Reporter's Revision of Tent. Drafts Nos. 1-3, s. 601. In Australia, the proposed Bill required every public company to file everything with the stock exchanges that is filed with the Commission; *see* Corporations and Securities Industry Bill, 1974, s. 48(3) (Commonwealth of Australia).

exchanges by any widely-held company should also be filed with the commission.

In order to carry out the policy of uniform access to relevant investor information, issuers should also be required to file with the commission copies of documents distributed to institutional investors and investment dealers for analytical purposes, although the rule to this effect should be carefully formulated to avoid public filing of private documents not within the policy objectives of the rule. What is desired is to have a current file of all material information concerning large public companies together with periodic reporting of a general nature and specific reporting of material developments available to the public at large.

The major question to be addressed here, so far as continuous disclosure is concerned, is what entities should be required to become "reporting issuers". In considering this question we have reviewed other current legislative proposals. Ontario Bill 98 proposes four categories of reporting issuers:

(1) an issuer who has issued voting securities after May 1, 1967, in respect of which a prospectus or securities exchange takeover bid circular was filed with the Ontario Securities Commission;
(2) an issuer that files a prospectus or securities exchange takeover bid circular after the act comes into force, regardless of whether voting securities are involved;
(3) an issuer, any of whose securities have been, at any time after the act comes into force, listed and posted for trading on the Toronto Stock Exchange;
(4) all companies incorporated in Ontario that are offering their securities to the public.[307]

Under the proposed *ALI Federal Securities Code* there would be two categories of registrant:

(1) a company with total assets of at least $1 million and 300 holders of its securities;
(2) any company that is required to file an offering statement, which is required whenever there is a non-exempt distribution of securities, either debt or equity.[308]

307 Ontario Bill 98, s. 1(1)35. The extension for Ontario companies in the fourth line effectively catches all Ontario companies that have ever filed a prospectus in Ontario. If the corporation has less than 15 security holders it can apply to the commission for relief; *see* Ontario Business Corporations Act, s. 1(9); Ontario Bill 98, s. 84. "Voting security" is defined to be a security other than a debt security carrying voting rights at the time; *id.* s. 1(1)4.

308 ALI Federal Securities Code, Reporter's Revision of Tent. Drafts Nos. 1–3, ss. 401, 501. There is a complicated provision where a secondary distributor in effect forces a company to become a registrant against its wishes. The company can, under limited circumstances, buy out the would-be distributor. Both Ontario Bill 98 and the code provide for voluntary registration, a concept we support only if the

Thus both Ontario Bill 98 and the *ALI Federal Securities Code* extend the coverage of corporations subject to the continuous disclosure regime to companies with no public equity holders. The *ALI Federal Securities Code* is consistent as it provides for a registrant to send "to every record holder of its securities" whatever reports the commission requires by rule "to keep investors reasonably informed with respect to the registrant". The comments to this section in the first draft show that the reporter intends the annual report to be the "central device for continual disclosure" and intends it to be sent to debt holders as well as to equity holders. There is no requirement in Ontario Bill 98 for an annual report, in the sense of anything other than financial statements,[309] to be prepared at all nor is there a requirement for anything to be sent to security holders generally. There is a requirement to send an information circular with proxies to voting security holders in certain cases.[310] We accept that the focus in Canada is still on reports to shareholders and we believe it should remain there as it is shareholders who have been the promoters of expanded disclosure.[311]

We propose that every enterprise with over 300 public holders of equity securities should be a reporting issuer. We would define an equity security to mean a share in a company or similar security as well as any security convertible, with or without consideration, into such a security or carrying a warrant or right to subscribe to such a security or any such warrant or right.[312] We would exclude from the term "public holders" any directors, officers or holders of 10% or more of the class of securities involved, together with their spouses, lineal ascendants and descendants. While we recognize that it is theoretically possible to have 300 holders of debentures convertible into common shares without any common shares in the hands of the public, we do not believe that it is usually an acceptable type of security to have in the hands of the public. There will no doubt be peculiar cases where the formula suggested would not work and the commission should have power to exempt any corporation from the reporting issuer requirement on the application of

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commission first gives its approval. We believe the advantages of reporting issuer status are only appropriate if the corporation involved is one that financial analysts are likely to follow.

309 Ontario Bill 98, s. 79.

310 *Id.* s. 85.

311 The promoters of expanded disclosure in the United States have also been shareholders; *see* Blumberg, *supra* note 123; Medical Committee for Human Rights v. SEC, 432 F.2d 659 (D.C. Cir. 1970). In Canada, the statutes now encourage shareholder proposals; *see* Canada Business Corporations Act, s. 131.

312 This definition is taken from ALI Federal Securities Code, Reporter's Revision of Tent. Drafts Nos. 1-3, s. 232.

either the enterprise involved or the stock exchange on which the listing is being requested. The commission might, for example, exercise this exemption power for large professional corporations which are essentially partnerships, or for corporations which have attained the over-300 level through inheritances from an initial, small group of shareholders or other events beyond the control of the corporation. Similarly, the commission should have the power to require any company which has over 300 holders of its debt securities to become a reporting issuer; we doubt that frequent exercise of this power will be necessary, but it will put the commission in a position to ensure adequate information is available to holders of widely distributed debt securities if necessary.

A comment is appropriate here as to the operation of secondary markets in equity securities – a topic that goes beyond disclosure but has important implications as to disclosure. Currently, the bulk of dollar value of equity trading in the Canadian secondary markets appears to be conducted through the stock exchanges, but a significant volume of trading occurs off the exchanges. This principally comprises trading in unlisted securities; but there has been some development of an over-the-counter market in listed securities. In our view, it is preferable for secondary markets to be carried on through an exchange or other central facility; this contributes to availability of anti-manipulative techniques and controls, adds to public information about the markets, and contributes to depth and liquidity. We have considered whether to recommend a requirement that any corporation with over 300 equity security-holders be required to obtain an exchange listing, but have concluded that such a requirement might not currently be appropriate in Canada for technological[313] and regulatory[314] reasons.

This does not preclude mandatory listing as a desirable policy objective, and we recommend that this objective be sought. We note that in England there is effectively no over-the-counter market and that in the United States major initiatives are in progress with a view to the elimination of the over-the-counter market and its replacement by a combined central marketplace. Similar initiatives could, we believe, be pursued in Canada and would contribute to the effective operation of the securities markets from many standpoints in addition to disclosure. We believe that this should be a principal objective of regulatory authorities,

313 The technological difficulties, and proposed innovations to overcome them, are set forth in *Cleland*.

314 Currently, the stock exchanges have considerable regulatory authority over listed companies. Mandatory listing would mean that at least one important aspect of this authority - the power to delist - would be assumed by the commission.

although the ultimate implementation of such a major change ought not to be carried out without legislation.

The proposals above contain no equivalent to the $1 million gross asset limitation set out in the proposed *ALI Federal Securities Code* in the United States. We believe that valuation problems are too difficult to warrant the insertion of what might prove to be an irrelevant standard. There are very few companies with over 300 public shareholders which have less than $1 million in gross assets except the speculative mining organizations. It would not be appropriate to exempt those organizations from any of the reporting provisions unless a separate set of regulations is tailored to their needs. There will be the unusual case, of course, of corporations with over 300 public shareholders where reporting issuer status would be unduly onerous, but this could be handled under the general power of the commission to exempt, recommended above.

We also believe that any organization should be entitled to apply to register as a reporting issuer but such registration should be at the discretion of the commission if the threshold levels are not met. This is not the position adopted in the United States draft code or in Ontario Bill 98. Under Bill 98 the would-be reporting issuer has a right to so become upon filing a prospectus. The justification for the special treatment of reporting issuers in the application of prospectus filing and other disclosure requirements is the assumption that they are followed by analysts on a continuous basis. As noted below, we are concerned that this assumption may not always be justified even where the 300 shareholders requirement is satisfied. To provide the reporting issuer status to corporations whose shares are less widely distributed would detract further from the validity of the assumption. We would therefore recommend that the Bill 98 proposal be varied by permitting a corporation with less than 300 shareholders to become a reporting issuer only with commission consent. Correspondingly, the commission should have power to deny the status to a corporation with more than 300 shareholders, a power it should exercise if satisfied that the corporation is not followed by analysts or is abusing its special privileges.

A few additional comments are in order as to the scope of application of the obligation to register as a reporting issuer. Since the requirement would be applicable only to issuers with over 300 holders of their equity securities, we do not believe that many major exemptions should be provided. Some special provision may be necessary after technological and regulatory difficulties are resolved so that equity securities of all reporting issuers can be required to be listed for trading in the secondary marketplace; for

example, once the number of equity holders or the distribution patterns of the stock of an issuer falls below the minimum standards at which listing is feasible, it might be necessary to end the listing requirement but reporting should not end until the commission is satisfied that there is no longer a sufficient public interest to justify continuous reporting. In so deciding the commission would take into account not only the question of whether there were debt security holders whose interests still required reporting[315] but also whether other statutory policies indicated that public availability of information was desirable.[316]

The only exemptions from reporting issuer status that we would foresee as not needing commission approval would be:

(1) Enterprises such as mutual insurance companies where the policyholders in effect own the company. To require these companies to list on a stock exchange would not be feasible. The authorities in charge of insurance companies should however ensure that adequate public reporting is maintained.
(2) Enterprises which are directly regulated if, but only if, an adequate disclosure policy is enforced by the directly regulating authority and to register under the Canada Securities Act would be largely an exercise in duplication. We would not except any general category of enterprise from this requirement.
(3) Not-for-profit corporations, such as social clubs, charitable organizations, etc.

Obviously a foreign entity, whose securities were not traded on Canadian stock exchanges, could not be expected to become a reporting issuer unless its securities were offered for sale in Canada. Even then a foreign entity should not be required to become a reporting issuer if similar disclosure provisions are complied with in its home jurisdiction and a copy of the information filed abroad is forwarded to the commission.

2. *Disclosure Requirements for Reporting Issuers*

The next question to be considered is what documents should be required to be filed by a reporting issuer, both initially and on a continuous basis. A spectrum of possibilities is available. We recommend above that public corporations be required to file with regulatory authorities copies of their annual and interim reports, press releases, and similar documents. At one end of the spectrum,

315 As in the OSC decision *In re* Toronto-Dominion Centre Ltd., *supra* note 160.

316 *See* Canada Business Corporations Act, s. 154(1)(b), which requires financial reporting by all businesses with assets over $5 million or gross revenues over $10 million.

this might be the only continuous disclosure requirement imposed on reporting issuers. At the other end of the spectrum, they might in addition be required to maintain at all times a prospectus standard of disclosure. Ontario Bill 154 – one of the ancestors of Bill 98 – originally adopted something akin to the latter approach with the "cornerstone prospectus". After many protests, this was abandoned in Bill 98 although the responsible draftsmen protested that they had not intended to go as far in Bill 154 as the protestors assumed. In the absence of draft regulations, it is not clear where on the spectrum of alternatives Bill 98 would place the Ontario requirements.

We have concluded against recommending either end of the spectrum. While filing of annual and interim reports, press releases and other documents will be a valuable contribution, it will not alone justify special privileges being accorded to reporting issuers. On the other hand, continuous maintenance of a prospectus standard of disclosure would be unnecessary and might well be impossible. Even if the legislation were to state clearly that confidential information need not be disclosed unless it "leaks" – a statement that seems essential if confidential corporate transactions are not to be prematurely disclosed – the complexity and frequency of the decisions faced by those responsible for the continuous updating would often be mind-boggling. Further, practical experience indicates that the production of a document which satisfies prospectus standards even at a particular time in connection with a particular issue requires a major joint effort of the issuer, the underwriter, their respective legal counsel, and the auditors of the issuer. A requirement for continuous adherence to this level of disclosure would either bring the law into disrepute or impose unwarranted expense on issuers.

We have concluded that our recommendation should adopt a position along the spectrum which reconciles workability with public access. A number of items would be specified as to which information would be required and updated on a continuous basis. These items would include a description of outstanding securities and basic financial and other information as to the issuer, producing a result somewhat like an expanded version of the Financial Post card service now available. The information to be set out should also include projections, and perhaps the time has come to have financial statements prepared in accordance with inflation accounting as well as in the standard format; a recommendation which should not be implemented without adequate consultation with the accounting profession.[317] Generally we believe the regis-

317 The U.K. is far ahead of Canada in this field. Accounting Standards Steering

tration statement should contain soft data useful to sophisticated investment analysts.[318] We believe that the Investment Dealers Association should be requested to assist the commission in developing a registration statement that is useful to financial analysts. Indeed we would encourage that organization to make periodic recommendations for desirable changes, if any, in the registration data so it would be more useful for analysts. We believe that positive accounting rules to permit comparisons on an industry-wide basis are likely necessary.[319]

The commission would perform a "blue sky" function at the time of registration of any reporting issuer not listed on a stock exchange.[320] For presently listed companies, it would be extremely onerous to check through the material filed before permitting registration when the statute is first promulgated. Accordingly, for example, all entities which have been reporting issuers for at least twelve months under the Ontario system or any other system of comparable extent could be given an automatic registration upon filing the basic document, which basic document could be reviewed at the earlier of the next new-issue prospectus filing by the company or when the commission found it desirable or possible to undertake a review.

We envisage the registration data to be kept in some sort of binder so pages could be updated regularly and previous pages removed, although the previous pages should be kept available for examination for a period of, say, six years. Once the stock exchanges have developed adequate dissemination techniques to assure accessibility of the data to exchange members, copies would be sent to all the recognized stock exchanges and perhaps to major

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Committee, Statement of Standard Accounting Practice No. 7 (May 1974) urged all companies listed on the London Stock Exchange to supplement their annual accounts with a general-index-adjusted balance sheet and statement of profit; *see* Morley, *Inflation Adjusted Profit As a Basis for Taxation*, CANADIAN TAX FOUNDATION, 1974 CONFERENCE REPORT 482 (1974).

318 Another type of disclosure that seems to us to be desirable but requires further consideration is disclosure by financial institutions of their portfolio investments and portfolio transactions as now required in the United States; *see* Securities Exchange Act of 1934, s. 13(f). It is beyond the scope of this paper to delve extensively into the detailed definitions required to specify what must be reported. We make no comment on discretionary accounts such as trusts, managed by financial intermediaries.

319 *See* Kripke, *supra* note 128.

320 It would, of course, be necessary for the commission to recognize that "blue sky" has a different connotation here than in the context of a new issue of securities. With a new issue, requirements can be made and the issue can even be rejected without severe detriment, except perhaps to the issuer. Similar requirements imposed as to outstanding securities would be very different, and the "blue sky" review of an already public issuer should not reject that issuer from reporting issuer status except in a flagrant situation.

libraries. They would be open to public inspection at any time. We would envisage that the stock exchanges and the Investment Dealers Association might arrange for a microfiche or computer system whereby the pages could be dialed into brokers' offices as required by salesmen or analysts. Disclosure to a few repositories would be the duty of the enterprise, availability would be the duty of the repositories, public dissemination would be up to the brokers and the media.

The major document we envisage being required for reporting to the general public by reporting issuers is the annual report, to be sent to all equity holders at least twenty-one days before the annual meeting of the company and within one hundred days after the close of the fiscal year.[321] The proposed Ontario legislation, carrying on the previous practice, leaves the requirement of dissemination to shareholders for the incorporating statutes.[322] While these statutes do require dissemination of annual financial statements, our suggested annual report would be a more extensive document. Just as the data in the registration statement, which would be regularly updated, is directed to analysts, we believe the annual report should be directed to the informed layman, however "mythical". The contents of the report will develop over time. Naturally, some form of comparative financial data will be included. We question however the utility to shareholders of the detailed financial statements now presented. We would support the inclusion of a five-year financial history. In addition to the required information, which should be presented in digestible form, the issuer should have the right to include other information as it sees fit, subject to the usual rules about misrepresentations and half truths. It should be possible to include in the document what is presently required in the information circular[323] so no separate document need be prepared.[324] The proxy itself could be enclosed or attached.

We have considered the question of preclearance of the mandatory parts of the annual report. We are concerned by the fact that Professor L. Loss, who is the leading authority in the field, puts so much emphasis on the preclearance aspect as essential to a properly functioning system.[325] In our view, preclearance would be a mammoth job for the commission. While we hesitate to dis-

321 Ontario Bill 98, s. 79, allows 140 days for the filing of annual financial statements. This seems to us to be a long time. The usual period in the United States is 90 days.

322 For a survey of the requirements as of 1968, *see* Bray, *supra* note 231.

323 Ontario Bill 98, s. 87.

324 We assume the provincial securities commissions would exercise their discretion to permit such an arrangement, which seems to be contemplated under Ontario Bill 98, s. 89(2).

325 *See* ALI Federal Securities Code, Tent. Draft No. 1, at 120–21.

agree with Professor Loss we believe that no requirement for preclearance should be built into the statute itself but provision should be made so that the regulations could require preclearance if that turns out to be necessary in practice. Thus we support the concept of certain data being included, which could be changed by the commission under its rule-making authority, but without commission review. We would be reluctant to see very much "soft" data required in annual reports at least initially. What is appropriate for sophisticated analysts may well be inappropriate for general distribution to shareholders. It is difficult to present such data properly without getting into confusing detail.

The last major area of continuous disclosure would be timely disclosure, with its ramifications of publicity and confidentiality. We agree with the suggestion in Ontario Bill 98 that most timely disclosure, if it is material and is not simply an updating of existing information, should be the subject of a news release. It is suggested that every press release filed with the commission contain a list of the newspaper chains or individual papers and of other news media to which the release was sent. This would allow the commission to ascertain whether nonpublication of an important press release was attributable to limited dissemination by the issuer.

The above remarks concerning timely disclosure are predicated on the assumption that issuers will be subject to a requirement to issue a news release for any material development. This again raises the knotty question of confidential information. It is clear to us that issuers should not be required to make premature disclosure of potential developments, even though material,[326] except that regulatory authorities should have power to require the disclosure if the information "leaks". The question is what requirement, if any, should be imposed to deal with a material but confidential development affecting a reporting issuer. Under Ontario Bill 98, a full press release would be required, which would be delivered to the commission with written reasons for nondisclosure. These reasons would be renewed every ten days if the issuer continues to regard the information as confidential. In our judgment, this requirement goes beyond what is justified by the problem involved; the arsenal of weapons available against improper nondisclosure should be adequate without the addition of such a major innovation. Further, we feel that acceptance by the commission of the responsibility involved in the Bill 98 proposal could have serious consequences for it. However some technique is needed to enable regulatory authorities to maintain a market watch on

326 Loss endorses the withholding of information for legitimate corporate reasons; *see* 6 L. Loss at 3596.

trading while confidential information is pending, and we therefore recommend that issuers be obligated to notify the commission when such information exists, without providing details except when requested by a senior officer of the commission. If such a request was made, the commission should not have authority to release the information unilaterally.[327]

In summary, then, continuous disclosure requirements for reporting issuers would have three key elements: continuous updating of a filed document setting out required basic information about the corporation, inclusion in the annual report of certain information, and timely disclosure of material developments. Further, all relevant documents, including, as noted above, information sheets and similar material prepared for institutional investors and investment analysts, should be filed with the commission to ensure continuous public availability of a file containing all relevant information released by the issuer. Taken together, and combined with effective commission supervision, we have concluded that these requirements are sufficient to justify the exemptions described below that would be available for securities of reporting issuers from full application of the prospectus requirements. However, it is important that the exemptive pattern is predicated on the assumption that reporting issuers will be followed by analysts and that the commission should be prepared to exercise the various powers available to it to deal with situations where it concludes that the exemptions are being abused by corporations of which that is not true.

3. *Disclosure Requirements for Non-Reporting Issuers*

It is apparent that the continuous disclosure obligations upon non-reporting issuers need be substantially less onerous than those upon reporting issuers; this follows because the range of corporations included in the category is so wide as to make general rules inappropriate, and because adequate protection to deal with most situations is provided by general corporate law and by the prospectus requirements proposed below. However, this category of corporation is too important to be ignored in the formulation of continuous disclosure requirements.

We consider it important that the rules imposing penalties and creating civil liabilities for false or inadequate disclosure should rest as heavily on non-reporting as on reporting issuers. In the United States, the vast accumulation of case law under Rule

327 The remedies for improper use of confidential information are discussed in *Leigh* and in *Yontef*.

10b-5 has done much to avoid fraudulent or deceptive practices affecting small corporations. While we do not concur with the scope of some of the remedies granted under that rule,[328] their principle seems to us appropriate and we believe (although the topic is not squarely within the scope of this paper) that the Canadian law in this area should be expanded.

Reference is made above to reliance on corporate law to ensure at least a basic minimum of information for the security holders of the non-reporting corporation. Requirements of Canadian corporate statutes as to disclosure are disparate, and those of foreign jurisdictions whose corporations may from time to time sell securities in Canada are even more so. It might well be appropriate to include in Canadian securities law provisions enabling the commission to require a non-reporting issuer to adhere to disclosure standards at least as extensive as those of the major Canadian corporate statutes.

In some cases, the commission should have even wider authority. Of necessity, the rules we propose embody precise numbers; more vague rules would create confusion and add to the administrative burden. The difficulty with rules embodying precise numbers is, of course, that persons wishing to avoid their application might be able to "plan around" them – for example, by making a public distribution to 299 purchasers. To avoid such abuses, we believe that the commission should have the power, where satisfied that a corporation was abusing its non-reporting status, to require compliance by it with the full continuous disclosure obligations of reporting issuers. This could be done with or without giving to the corporation concerned the status of a reporting issuer.

Except for the discretion in the commission to so require, we would not propose to have any general continuous disclosure requirements for non-reporting issuers. The commission would not be a repository of information for such corporations. They would not be required to file annual reports, information circulars or insider trading reports. We would stress that such entities have fewer than 300 public shareholders and hence their shares are not traded in the marketplace regularly. It is disclosure for the purpose of informed secondary trading that is the investor protection aspect of continuous disclosure. Where no substantial secondary trading exists the need for continuous disclosure to protect investors cannot be demonstrated.

328 Recent cases in the United States Supreme Court suggest that substantial limitations will be imposed on the previously broad scope of Rule 10b-5; *see* Ernst and Ernst v. Hochfelder, 98 S. Ct. 1375 (1976).

C. PROSPECTUS DISCLOSURE

From the standpoint of investor protection, which is the touchstone of securities regulation, the arguments in favour of full and complete disclosure in respect of securities offered to the public on an initial distribution apply equally in respect of outstanding securities that are publicly traded in the secondary market.[329] However, the cost of prospectus-type disclosure, as that has evolved in Canada today, is such that it cannot rationally be required in the average small transaction which occurs daily on the stock exchanges. Even an abbreviated form of required disclosure would be impractical for such transactions. It might be possible to have every seller in the secondary market required to make a statement, to which liability could attach, that he has no knowledge of any material change which has occurred in the affairs of the issuer of the securities which has not been generally disclosed.[330] But that is not disclosure at all, although its utility in certain circumstances is not to be denigrated.[331]

It is possible to suggest that a spectrum of disclosure documents be used on secondary trades with a complete, prospectus-type document being reserved for new issues and large distributions of stock not previously held by the public. While the cost justification of such a spectrum is apparent, it is not clear what type of simple disclosure document would be appropriate on significant but smaller secondary trades. Indeed the amount of securities or their source may be less relevant than the ready availability of reliable information concerning the issuer and the securities involved. Thus our focus here is on the availability of information as well as on the source and size of the contemplated trade.

Under the Ontario proposals, a prospectus is required, unless an appropriate exemption exists, anytime there is a trade in a security which would be a "distribution".[332] A distribution occurs

329 Emerson, *supra* note 67, at 419.

330 The wording is taken from Ontario Bill 98, s. 73(7), which appears to be taken from the tag end of forms 144 and 237 under the Securities Act of 1933. It is interesting to note that in the United States, Form 144 relates only to material adverse information generally disclosed while Form 237 relates to any material information (whether or not adverse) disclosed to the buyers. The proposed Ontario legislation seems to catch both concepts. *See also* ALI FEDERAL SECURITIES CODE, Tent. Draft No. 1, s. 509 and comments, *id.* at 102–03.

331 Indeed, we would favour its inclusion in the statute in some situations where disclosure is impractical.

332 Ontario Bill 98, s. 54. The word "prospectus" is not a word of fixed significance from a disclosure point of view. The practice in both the United States and Canada involves the use of various forms of prospectus depending on the issuer, the type of security involved and even the amount of securities to be sold.

whenever the issuer sells[333] a security, whenever a sale comes from the holdings of a person whose total holdings materially affect control and whenever a security previously sold through a trading exemption is not resold pursuant to the statutory scheme. While a prospectus requirement is sensible in many of the situations encompassed under this scheme, there are also included cases in which a prospectus requirement seems inappropriate. Modern corporate statutes permit issuers to repurchase issued securities[334] and in some cases require repurchases at the option of the holder.[335] It seems odd that the issuer cannot resell such shares on the market, even in insignificant quantities, without filing a prospectus[336] while an insider who was not in a control position could freely sell the same number of shares with no disclosure at all. Similarly it makes little sense to say that if a person happens to control a company he cannot sell even a minor amount of non-voting securities without prospectus disclosure, except in some exigencies, whereas if the person does not control he can sell millions of dollars of stock without any disclosure.[337] Again in the same spirit, it seems harsh to require an employee who acquired stock pursuant to a stock option plan which is an exempt trade[338] to file a prospectus before he resells his ten shares if his employer is in default under the statute.

The proposed *ALI Federal Securities Code* in the United States has a different formulation, again based on the definition of a "distribution". Essentially a distribution in the *Loss Code* is any sale of a security except a "limited offering" or a "trading transaction". A limited offering is a sale to not more than thirty-five investors, excluding institutional investors from the count, which does not fan out within a three-year period[339] of the initial sale to more than thirty-five investors, again excluding institutions. Thus, so long as the group remains smaller than thirty-five during

333 Sell is used here to include "issue" as well as sales of previously issued shares. There is an English decision, Re V.G.M. Holdings Ltd., [1942] 1 All E. R. 244 (C.A.), which suggests that an issue may not be a "sale" but this is a rather silly distinction which is not in accord with the U.S. cases such as Ruckle v. Roto-American Corp., 339 F.2d 24 (2d Cir. 1964), nor with the reasoning in J.M.P.M. Ltd. v. Danforth Fabrics Ltd., [1969] 1 O.R. 785 (H.C.); *see also* ALI Federal Securities Code, Tent. Draft No. 1, at 48.

334 *See e.g.* Canada Business Corporations Act, s. 32.

335 *See id.* s. 168 coupled with s. 184 for one example.

336 The issuer could use the exemption in Ontario Bill 98, s. 74(1)(b), if it filed a statement of material facts.

337 Loss, *The American Law Institute's Federal Securities Code Project*, in ALI Federal Securities Code, Tent. Draft No. 1, at xxix, xxxvi.

338 Ontario Bill 98, s. 73(1)(l).

339 The period is one year for reporting issuers; *see* ALI Federal Securities Code, Reporter's Revision of Tent. Drafts Nos. 1-3, s. 227(b)(2).

the three-year period there is no distribution. A trading transaction is one effected through a dealer by a seller other than the issuer where the security was not acquired pursuant to a limited offering and the total trading transactions of the seller do not exceed some maximum volume which the commission can specify by rule.[340] The definition of "distribution" groups together both primary and secondary transactions in both proposals. For purposes of analysis it may be better to separate primary from secondary distribution. So far as primary distributions are concerned, the proposed Ontario legislation has an exemption for an "isolated trade" by the issuer for its own account. But this vague standard is not as easy to apply as a bright-line test if one can be satisfactorily fashioned. We would prefer the issuer, if he is a reporting issuer, to have an exemption more like the trading transaction exception in the *Loss Code*.[341] Ontario Bill 98 also contains an exemption which is a quasi parallel to the limited offering concept of the *ALI Code*, but only applies where there are less than twenty-five sophisticated purchasers from an issuer.[342] Why this exemption should not extend to secondary distributions by a controlling person is not clear. While we like the sophisticated purchaser concept as an investor protection device, we would think the number of purchasers could be broadly expanded if only sophisticated purchasers are involved and no restriction on the source of the securities is necessary.

Accordingly our basic suggestion on primary distributions is to require a prospectus but to have two broad exemptions – one for sophisticated purchasers and one which allows the issuer, if he be a reporting issuer, to dispose of not more than a set volume of securities over a given time period, the numbers to be specified in the rules. For non-reporting issuers we would suggest an exemption similar to the limited offering exemption of the *ALI Federal Securities Code*, with the same limit of thirty-five purchasers within a three-year period. While this compromises the investor protection approach to some extent, there must be a balance struck between complete disclosure to an investor and the ability of a small enterprise to develop an expanding base of security holders. It would be inappropriate for Canada to take a more restrictive stand that would discourage the growth of small domestic produc-

340 *Id.* s. 227.

341 While the trading transaction specifically excludes the issuer in the definition sections of the ALI Federal Securities Code, there is provision for the commission to waive the rule in favour of the issuer and this is contemplated by Loss; *see* ALI Federal Securities Code, Tent. Draft No. 1, at 22.

342 *See* Ontario Bill 98, s. 73(1)(m). The holding period on resale is effectively imposed under *id.* s. 73(4).

ers. On the other hand a wide distribution of even a fairly small amount of shares calls more clearly for some disclosure, which disclosure will be available through continuous disclosure in the case of reporting issuers. It is therefore appropriate to have a narrower exemption for non-reporting issuers.

In so far as secondary issues are concerned the problem is exacerbated by the fact that, until now, no restrictions have been placed on the right of institutional purchasers to later sell their portfolio investments into the marketplace without filing a prospectus no matter how many shares are involved. Before the provincial statutes required an investment intent to justify exempting institutional purchasers, institutions sometimes bought large amounts of shares for which no prospectus was ever filed and promptly distributed them to the public. This obvious loophole is no longer available but the same problem exists so far as investor protection for the purchaser is concerned if any institution or individual can split up a large block of stock in the market on the basis of an exemption on original issue or on the basis that there was a prospectus at the time of original issue. The purchasers of the pieces of the large block are entitled to receive no disclosure at all under the present provincial system and, in many cases, will receive no disclosure document under the proposed provincial system. We seriously question whether such a system is adequate.

Thus on large secondary distributions, whether emanating from a control block or any other large block, we believe that a current prospectus should be required at the time of sale. However, we recognize that this recommendation would be foolish in the extreme if it seriously impacted on institutional investment. Institutional investors are a necessary part of most issues where small individual investors are involved. Without the institutions it would be impracticable to market the issues initially. If the obligation to file a current prospectus on a resale of a large quantity of stock purchased by institutions would have a material adverse impact on institutional investment then this recommendation should not be implemented and other methods of investor protection should be canvassed. We doubt that institutions, in practice, often exceed a resale volume that would not be covered by the trading transaction exemption suggested above for reporting issuers. But it could well be that the institutions would demand unacceptable covenants from the issuers as a result of the difficulty that might arise if a resale requiring a prospectus were subsequently desired by the institution. It is in that sense that we are worried that institutional investment might be adversely affected by our recommendation and we therefore would suggest that its

enactment be deferred until the government is assured that there will be no significant negative results.

In addition to the trading transaction exemption on secondary distributions, we would again recommend a limited offering exemption for non-reporting issuers and a sophisticated purchaser exemption. The sophisticated purchaser for the purpose of both the primary and secondary distribution exemptions would include institutional purchasers, purchasers of over $100,000 blocks[343] and investors who by net worth and investment experience or by virtue of consultation with or advice from a registered investment dealer are able to properly evaluate the prospective investment on the basis of information supplied by the seller.[344] While it seems hardly necessary in theory to put a limit on the number of such purchasers of any one distribution we believe an overall limit of say one hundred purchasers should be established in order to prevent truly public distributions with everyone buying through an investment adviser. While one hundred is obviously arbitrary it reflects our view that numbers such as twenty-five are unnecessarily restrictive.

We also believe that the commission should have the right to demand that the issuer file a prospectus and that registered dealers distribute it on all sales when heavy secondary trading occurs in the marketplace even if no single seller is required to file a prospectus under the proposals previously set forth. We are aware that this is an extraordinary remedy and should only be used in extraordinary circumstances. The prospectus would not carry the same liability as a new issue prospectus in the sense of a rescission remedy nor could it be expected to contain information of a confidential nature. On a new issue the issuer can choose the timing of the issue to avoid the necessity of confidential disclosure but such would not be true on a prospectus filed as envisaged hereunder. The issuer has little or no control over market activity in many cases. On the other hand, the concept of investor protection demands that investors be supplied with up-to-date information if a highly unusual amount of trading is taking place. At present the provincial commission can only issue a cease trading order in cases of unusual trading which order may not be an appropriate remedy as it precludes trading by the portfolio investor who bought on the assumption that he could sell his investment at any time. Often a cease trading order is put on temporarily until a material change is disclosed by a press release and we would

343 The standard provincial number is $97,000, introduced in 1967 apparently to take care of a slight discount on $100,000 purchasers. If $100,000 blocks are very frequent in actual marketing practice we would retain the $97,000 limit.

344 The wording could be copied from Ontario Bill 98, s. 73(1)(m).

envisage that such a procedure would be adequate in most cases. However the commission should have the power to demand a prospectus if genuinely necessary for investor protection under the circumstances and we so recommend.

Assuming that a prospectus is necessary for a secondary distribution the present provincial system of requiring the issuer to provide the information should be adopted[345] although it should be made clear that, in the case of one major seller, the seller should bear the reasonable costs of the issuer in getting the information together and should have the same liability as an underwriter for incorrect statements and completeness, *i.e.*, liability if he has knowledge of any inaccuracies. Because we would not require an issuer to become a reporting issuer at the time of any issue requiring a prospectus (as Ontario Bill 98 requires) we can avoid the difficult question of the propriety of forcing reporting issuer status upon an unwilling issuer with relatively few securityholders. We believe the avoidance of that problem is an important argument against reporting issuer status without 300 shareholders. The problem is ignored in Ontario Bill 98 while the solution adopted in the proposed *ALI Federal Securities Code* is cumbersome at best.[346]

As we have stressed repeatedly throughout this paper we believe the commission should have a broad exempting authority. In this area the authority would extend to waiving the prospectus requirements anytime it believed that to do so would be in the public interest.

When a prospectus is required we have stated above that we do not see the merit in retaining on a compulsory basis the present preliminary prospectus requirements. Indeed only four provinces currently have provisions for preliminary prospectuses in their legislation and British Columbia conspicuously avoided it when its current statute was enacted. In the United States where the concept first developed, the proposed *ALI Federal Securities Code* has backed away from a mandatory preliminary prospectus although there is provision for the issuer to utilize one on a voluntary basis.[347] We do not think the system has worked in Canada and we think it is time it was scrapped. On additional issues by reporting issuers there is no reason to have a "waiting period" as our scheme would envisage a constant assessment of the issuer by analysts in

345 *See id.* s. 65.

346 *See* ALI Federal Securities Code, Tent. Draft No. 1, at 83-87.

347 *Id.* s. 504(b). The voluntary basis is designed to solve the "California problem" of getting prospectuses to the West Coast from the eastern financial centres; *see id.* at 90. It is interesting to note that British Columbia is the one "Uniform Act" province without a preliminary prospectus.

the case of most large firms and detailed scrutiny of the prospectus by the commission in default of such assessment. On first issues we see the commission as having a much more serious "blue sky" function, which in part replaces the functions of the waiting period. In any event, there will be presentations on new issues by the underwriter to the banking or selling groups and it is these dealers who effectively disseminate information during the waiting period. We believe that little or no solicitation of the public presently takes place until immediately before the underwriting agreement is signed, which occurs at the end of the waiting period, so the waiting period is likely useless for business reasons anyway. If the brokers know their clients sufficiently well to anticipate what information the client should require before purchasing securities, this will be more effective than having lists of people to whom preliminary prospectuses and amendments might be sent. Disclosure of even the most pessimistic type[348] has proved no deterrent to the sale of rotten eggs, particularly when a hot issue market exists.[349] In short, the concept of a preliminary prospectus as a mandatory document to be sent to prospective purchasers during the waiting period is not sufficiently useful to justify its retention. We would however favour the requirement of filing a draft prospectus, signed by the chief executive officer and chief financial officer of the corporation, which draft would form part of the public record until the receipt for the final prospectus was obtained. The draft should be filed concurrently with or prior to any approaches to institutional investors.

Turning to the contents of the prospectus we believe that the amount of material can and should vary with the stature of the issuer and the type of securities involved. Thus a $50 million secured debt issue of a major Canadian industrial corporation with a debt equity ratio of less than unity should not call for the same prospectus disclosure as a first issue of shares by a newcomer on the industrial scene. The available information from the reporting issuer files will be adequate for analysis of everything except current undisclosed information and the details of the proposed issue itself. While we do not wish to suggest reliance on debt equity

348 The most amusing pessimism, which the commission felt was a put-on and refused to accept, said, *inter alia*:

> "The present directors do not foresee the possibility of the corporation ever being in a position to pay any dividends or having any assets of determinable value. The continued existence of the corporation is questionable. Bankruptcy may result at any time."

Holmes v. Cary, 234 F. Supp. 23 (N.D. Ga. 1964).

349 *See* Panel, *New Approaches to Disclosure in Registered Security Offerings*, 28 Bus. Law. 505 (1973), for trends on how to disclose in a hot issue market; and *see* particularly the remarks of Mr. Grienenberger, *id.* at 518.

ratios or other bright-line tests to determine which issues need less disclosure we do believe that on debt issues of reporting issuers, a summary prospectus would be adequate except in unusual cases. The same type of disclosure would be adequate on further issues of shares by reporting companies so long as the further issue did not dramatically increase the number of outstanding securities. We also believe that the commission should not review these blue chip filings at all, leaving the civil liability sanctions as sufficient deterrent to incorrect statements.[350]

On the other hand we believe that a set of guidelines should be developed below which even reporting issuers would have to prepare the equivalent of a full prospectus with a prospectus summary at the front,[351] unless the commission agrees to waive the full prospectus requirement, on new issues within the guidelines. These prospectuses would be vetted by the commission in much the same way as prospectuses are today, with a limited "blue sky" emphasis. For secondary distributions of reporting issuers which require prospectuses under our suggestions, we also believe commission vetting is appropriate initially to check that suitable disclosure is being made, including, in the case of sales by insiders, a statement of the reasons why the seller is selling.

On public offerings of securities of non-reporting issuers we believe a prospectus is appropriate although again we see no reason for the commission to vet it extensively on debt issues where the equity base is adequate. Where the issue is a new stock, however, in the sense that it has never been offered before to the public, or is a debt security with only a marginal cushion, a full prospectus is in order with a very strict "blue sky" vetting by the commission. While we do not believe that a legend should appear on the face page assuring the investor that such a vetting has occurred we do believe that the commission should recognize that investors do, in fact, assume that the commission has thoroughly investigated the merits of new security issues. We believe the commission should act accordingly although we do not wish by this suggestion to cut down new issues dramatically as we believe new ideas brought out by new entrants in a market are stimulating to the whole economy.[352] We believe the commission staff should spend its time helping the originators disclose their facts in a way that is meaningful to the public and also in making sure that the

350 *See* the interesting comments of Marsh, *id.* at 531 where he suggests that commission intervention has made prospectus writing a joint effort which has produced an abortion.

351 A prospectus summary is not to be confused with a summary prospectus.

352 Dynamic competition is the usual phrase in economic literature and is championed by J. SCHUMPETER, *supra* note 118.

scheme moves money into the enterprise as opposed to into the hands of the promoters.

On the content of prospectuses generally, we accept the criticism of Judge Weinstein when he said:

> "In at least some instances, what has developed in lieu of the open disclosure envisioned...is a literary art form calculated to communicate as little of the essential information as possible while exuding an air of total candor. Masters of this medium utilize turgid prose to enshroud the occasional critical revelation in a morass of dull and – to all but the sophisticates – useless financial and historical data."[353]

We realize we are simply joining a chorus when we recommend that clarity of communication in a narrative style must be a continuing goal. So far, prospectuses written by lawyers and vetted by administrative officers have proved to be difficult to read. How to turn lawyers into artists is beyond our competence.

Finally we would recommend that soft data be included in prospectuses if at all on a permissive rather than a mandatory basis. Examples might include plans, expectations and financial projections which have always been a part of the modern prospectus disclosure in England and have been permitted for several years now in the United States. On the other hand we would favour the compulsory inclusion of different financial reporting techniques on a comparative basis – *e.g.*, what would inflation accounting do to the profit picture – if such disclosure can be accomplished in a meaningful way. We also support bar charts or graphs for five-year projections as long as one is careful not to allow the picture so formed to be distorted by the use of unrealistic scales or similar devices.

Before leaving this section we wish to comment on the scheme of protection for the little investor buying from another little investor where no prospectus is required. In most cases we believe the seller is as ignorant of salient facts as the buyer although we would favour a requirement of a "no knowledge of any undisclosed material facts" report to the commission by any insider buying or selling at any time. The chief protection for the little investor buying from another little investor would be through his broker. We envisage that the broker, where he questions the suitability of any particular investment for any particular client (which questioning the broker should be encouraged to do under the "know-your-client" rules) should encourage him to reconsider his decision

353 Feit v. Leasco Data Processing Equipment Corp., 332 F. Supp. 544, 565 (E.D.N.Y. 1971).

relatively quickly so the transaction can be unwound in the marketplace, with relatively little loss, if necessary.

D. EXEMPTIONS

While we have already set forth our basic plan for exemptions in the continuous disclosure and prospectus disclosure sections, we believe we should review the existing[354] and proposed exemptions under the Ontario legislation as well as the major existing exemptions in the United States and the proposed exemptions in the *ALI Federal Securities Code*[355] to indicate how they differ from our proposals or where they fit under our proposals. It is not necessary to discuss the exemptions from reporting issuer status as these have been covered above. Accordingly we will concentrate on exemptions from the prospectus requirements. We will deal first with the trading exemptions and then with the exemptions based on the type of security issued.

Perhaps the most important exemption from initial issue disclosure under the present provincial laws is the sophisticated purchaser exemption which is sometimes lumped in with the private placement exemption[356] although logically the two are quite separate. The reason for exempting the sophisticate is either that he has no need for the information because he already knows it or he has the market power and the expertise to get what information he wants. It would be a waste of money therefore to impose disclosure requirements, so far as investor protection is concerned, as the purchaser is well able to protect himself. Under the present Ontario statute this exemption is in two parts: the purchaser who is exempted because of his status as a financial intermediary[357] – namely, banks, insurance companies and trust companies, persons acting on behalf of governments, dealers[358] and institutions[359]

354 The existing exemptions are the subject of an excellent article by Dey, *supra* note 247, to which the reader is referred for more complete information.

355 It will be recalled that the ALI FEDERAL SECURITIES CODE, Tent. Draft No. 1, does not define a "limited offering" or a "trading transaction" as an exemption but rather as an exception within the definition. As these concepts have been stressed earlier in the paper, they need not be repeated here.

356 Dey, *supra* note 247, calls the $97,000 exemption the private placement exemption and this is the popular name for it. But there is no "private" concept in the exemption. Nor is the placement of debt securities with several insurance companies necessarily a "private" placement. The reason for the exemption in both cases is a belief that the purchaser can fend for himself. In this sense, he is a "sophisticated purchaser".

357 Ontario Securities Act, s. 19(1)3.

358 The dealer exemption is in s. 58(1)(d) of the Ontario Securities Act and in s. 73(1)(n) of Ontario Bill 98.

359 The section as presently worded does not permit the commission to recognize an

recognized by the commission as exempt purchasers – and purchasers other than individuals, whose aggregate acquisition cost is not less than $97,000.[360] Any number of such purchasers may buy securities without triggering the prospectus requirements. These two types of sophisticated purchaser exemptions are carried forward substantially unamended in Ontario Bill 98.[361] Both the statute and the bill provide that a trust company will be deemed to be acting as principal when it trades as a trustee for fully managed accounts but apparently this would not be so for banks or other institutions[362]

There is an institutional investor exemption in the *ALI Federal Securities Code* as well but there is no $100,000 purchaser exemption.

We agree with the Ontario exemptions in this area, except for the proposed limitation that only trust companies can trade for managed accounts, as we believe the institutions and the larger purchasers are able to look after themselves. These would be covered in our proposals by the sophisticated purchaser exemption.

The second major exemption concept is that only public offerings of securities should require prospectus disclosure. This is accomplished under the present provincial statutes by limiting the scope of the substantive requirements rather than by utilizing the exempting sections. But there is also an exemption provided for trades in a security of a company in connection with an offer to purchase shares by way of private agreement with fewer than fifteen shareholders or an offer to purchase all the shares in a private company.[363]

The proposed Ontario legislation abandons this pattern entirely. There is no limitation of the scope of the disclosure requirements to public distributions. Instead all primary and secondary primary offerings are subject to prospectus disclosure unless an

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individual, however sophisticated, as an exempt purchaser. While this is theoretically difficult to justify it probably is irrelevant in practice.

360 Ontario Securities Act, s. 19(3). The theory which Dey suggests to explain why individuals are excluded from this exemption, namely, that organizing into a corporation or partnership shows some degree of sophistication, is somewhat less than convincing.

361 Except that the restriction to persons other than individuals in the $97,000 exemption has been dropped; *see* Ontario Bill 98, ss. 73(1)(a), (c).

362 Loss says that it is implicit that banks and insurance companies are institutional investors when buying for accounts under their management; *see* ALI Federal Securities Code, Tent. Draft No. 1, at 29.

363 Ontario Securities Act, s. 19(1)9a. Complementing this is the security exemption in s. 19(2)9 for securities of a private company issue by the private company "if the securities are not offered for sale to the public".

exemption is available. The major exemption of a private offering nature is one which is limited to twenty-five sophisticated investors[364] in situations where there has been no market grooming. This concept is adopted in part from the *ALI Federal Securities Code* but there is no restriction in the code that the investors be informed. It will be recalled that, under the proposed *ALI Code*, the "limited offering" exception was one which did not fan out to more than thirty-five people in under one year, for reporting issuers, and three years for other issuers. The proposed Ontario exemption only allows twenty-five beneficial owners as a result of this procedure over the life of the issuer. Presumably the "beneficial owners" in Ontario would not include subsequent transferees of the securities or the exemption would be very narrow indeed and hard to keep track of, although this is not clear in the statutory language. If it does include transferees then there is always the question of whether the securities transferred derived from the exempt sale or were from other securities acquired in the market by the vendor.[365] It would appear to make more sense to follow the proposed U.S. pattern in this particular case. It is also unnecessary to confine the number of offerees as contrasted with purchasers and we recommend that this concept not be followed in any federal legislation.[366] We do agree with the idea of not permitting general advertising to the public.[367]

The most troubling concept in the proposed Ontario private placement exemption is the requirement that the purchaser be a sophisticated investor, although we approve of this requirement as the basis for a separate exemption. We think that the Ontario proposal is confusing the "need to know" concept with the private placement concept.[368] A private placement is not subject to disclosure requirements because there is no public interest and not because of any need to know criterion. Thus sales of shares in a private company can be made to the most uninformed because there is no public interest. Why should there be a distinction on initial private distributions of other than private companies? Of course resales from this type of placement will need to be circumscribed and this has been recommended in both Ontario Bill 98 and the *ALI Federal Securities Code*. While it is attractive to say that only the sophisticated may buy, it is unrealistic with respect to

364 Ontario Bill 98, s. 73(1)(m).

365 *See* ALI Federal Securities Code, Tent. Draft No. 1, s. 227(b)(8), which specifically covers this question.

366 *See id.* at 16.

367 *See* Ontario Bill 98, s. 73(1)(m)(iii); ALI Federal Securities Code, Tent. Draft No. 1, s. 502(b).

368 The idea of having a naive offeree with an informed adviser was first suggested in Note, *Revising the Private Placement Exemption*, 82 Yale L.J. 1512 (1973).

small ventures where the purchasers are often direct participants. To force all such ventures into the "private company" definition, particularly when that definition is being abandoned for corporate law purposes, is unnecessary. The proposed Ontario system allows anyone who wishes to sell to fifty persons to do so by utilizing a legal form called a private company, while stoutly maintaining an investor protection stance for other forms of enterprise. To allow form to govern substance in this manner is regrettable.

We believe that there are two obvious alternatives to meet this problem. The first is to allow a limited sale to say thirty-five persons, excluding institutions, regardless of sophistication. This is the *ALI Federal Securities Code* formulation. The second is to allow only the most circumscribed private offering – to direct participants in the business, their spouses, lineal ascendants and descendants. We believe the first option is the more appropriate. The private placement exemption would make it unnecessary to have several of the additional trade exemptions for the issuer proposed in Ontario Bill 98. Thus an isolated trade exemption[369] would be unnecessary, an exemption for purchasing assets in exchange for shares would be unnecessary,[370] an exemption for an exempt takeover bid would be unnecessary[371] and an exemption for a trade by the issuer to its promoters would be unnecessary.[372] Thus we recommend an exemption for sales on primary issues to less than thirty-five purchasers, in accordance with the scheme set out in the *ALI Federal Securities Code* for "limited offerings".

The sophisticated purchaser exemptions together with the private placement exemption form the major distributive exceptions from prospectus requirements on primary distributions. The securities placed under these exemptions have, by definition, never been distributed to the general public. The question becomes then whether a secondary distribution of such securities should trigger some sort of disclosure requirement? This problem has been of central concern to the reforms recently suggested in

369 Ontario Bill 98, s. 73(1)(b).

370 *Id.* s. 73(1)(j), which is carried over from s. 19(1)9b of the current statute. *See* Dey, *supra* note 247, at 160, where he points out that this asset exemption as presently worded is really aligned to the $97,000 rule.

371 Ontario Bill 98, s. 73(1)(i) which is carried over from Ontario Securities Act, s. 19(1)9a. *See* Dey, *supra* note 247, at 160, for a note on the problems with the wording under the present statute which Ontario Bill 98 remedies.

372 Ontario Securities Act, s. 19(1)9c. The exemption was only added in 1971 and, as is pointed out by Dey, *supra* note 247, at 162, was likely unnecessary so far as prospectuses were concerned because a sale to a promoter is not a sale to the public.

both the United States and Canada. In the United States the Securities Act of 1933 only required a prospectus if the purchaser purchased a security from an issuer with a view to its subsequent distribution. This was interpreted to mean that the purchaser had to have an investment intent at the time of purchase,[373] a concept carried over into the current Ontario legislation.[374] This has proved a difficult concept to deal with in both jurisdictions and has been eliminated in both the *ALI Federal Securities Code* and Ontario Bill 98. Under the proposed *ALI Code* there is no necessary prospectus or disclosure requirement if the purchaser in a limited offering holds the securities for one year in the case of a reporting issuer or three years in any other case.[375] But all secondary distributions in excess of a fixed amount by one seller (initially set at $100,000) are subject to at least a distribution statement and, in the case of securities of non-reporting issuers, a full prospectus is required. Thus the code does provide for disclosure if a large block is subsequently distributed of a company about which there is no information publicly available. Ontario Bill 98 adopts a somewhat different pattern. It requires a prospectus on the sale of even one share of a non-reporting issuer which is derived from a private placement or sophisticated purchaser placement.[376] For reporting issuers, holding periods of between six months and eighteen months, depending on whether the securities are legal for life, are mandatory if prospectus-type disclosure is to be avoided. After that, so long as the seller has not groomed the market, there is no requirement for any disclosure; not even a distribution statement on the dispersion of a large block. While we believe that this legislation goes a long way in the right direction we are also of the view that it may not be adequate when a large block is distributed publicly, even two years after it was originally issued, depending on the depth of the market for outstanding securities of the same class.[377] We also believe that some minimal trading of non-reporting issuers may be appropriate without full prospectus disclosure. Yet some compromises are obviously required. As a result of a search for bright-line tests in this area, the Securities and Ex-

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Strangely enough, this exemption has been dropped in Ontario Bill 98 so a sale to a promoter is presumably a trigger for a prospectus under that legislation.

373 *See* WHEAT REPORT at 160.

374 *See* Ontario Securities Act, s. 58(1)(a); Ontario Securities Regulations, s. 11 and form 11; Dey, *supra* note 247, at 147.

375 The trading transaction is not available to the purchaser in a limited offering; *see* ALI FEDERAL SECURITIES CODE, Reporter's Revision of Tent. Drafts Nos. 1-3, s. 227(c)(1)(B).

376 Ontario Bill 98, s. 73(4).

377 If the market has no depth, grooming will be essential before sale so a prospectus would be required.

change Commission adopted Rule 144[378] under the current U.S. legislation. Essentially the rule has five separate components before a resale may be made without prospectus disclosure, which components, together with our comments, are as follows:

(1) There must be adequate current information publicly available with respect to the issuer of the securities being sold.[379] This criterion is satisfied under Ontario Bill 98 by requiring the issuer to be a reporting issuer, a condition which we believe is too onerous for sales to a small number of purchasers on secondary distributions of securities of non-reporting issuers.

(2) The securities have been held by the seller for an adequate period prior to resale.[380] This requirement was introduced in the United States to deal with the theory, developed as a result of the wording of the statute, that all distributions had to be the subject of a prospectus and one only lost the status of being part of a distribution if one held the securities for an adequate amount of time.[381] The concept has little to do with investor protection and, for disclosure purposes at least, should be ignored entirely. Accordingly we would not recommend any holding periods whether the securities are legal for life or not,[382] in view of the quantity restrictions which are imposed.

(3) There are limits on the amount of securities which can be sold.[383] Essentially the limits are that 1% of the outstanding securities of the class being offered or a number equal to the

378 SEC, Securities Act of 1933 Release No. 5223, January 11, 1972, [1971-1972 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,487, *amended by* SEC, Securities Act of 1933 Release No. 5452, February 11, 1974, [1973-1974 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 79,633. The basic idea was to change the area of the law from "theology to arithmetic"; *see* Panel Discussion, *Developments in Private Placements, Distributions of Restricted Securities; Rule 144*, 28 Bus. Law. 483 (1973)(F.M. Wheat). The phrase comes from an address by SEC chairman William Casey, *PLI, SEC Seminar* (February 1972). Rule 144 is still in its early phase and has been amended several times; *see* Castruccio & Tischler, *Developments in Federal Securities Regulation*, 31 Bus. Law. 1855, 1859 (1976).

379 *See* Rissman, *Rule 144: Manner of Sale and Availability of Public Information*, 67 Nw. U.L. Rev. 124 (1972).

380 *See* Flanagin, *The Rule 144 Holding Period*, 67 Nw. U.L. Rev. 87 (1972).

381 *See* Sommer, *Considerations Leading to the Adoption of Rule 144*, 67 Nw. U.L. Rev. 65 (1972).

382 We would point out that the "legal for life" requirement can be avoided (*see* TDRI prospectus of September 20, 1972). This does not mean that such securities are not more solid on the average than other securities. But solidity, without more, is not an acceptable basis for excluding disclosure requirements although it is an acceptable basis for precluding detailed commission review of the disclosure document.

383 Snyder, *Securities Regulation Rule 144 - From Lawyers to Mathematicians*, 40 Tenn. L. Rev. 399, 419 (1973); Wander, *Limitations on the Amount of Securities That Can Be Sold in Compliance with Rule 144*, 67 Nw. U.L. Rev. 111 (1972).

average weekly volume of sales of such securities on all exchanges for the four weeks prior to the placing of the sell order, whichever is the lesser, can be sold by any one private purchaser in a six-month period.[384] This is a "leakage" formula designed to allow a purchaser to dispose of securities where there is no undue disturbance of the trading markets.[385] It limits securities which can be sold without a prospectus to those bearing a reasonable relationship to the conditions existing in the trading market. It has little to do with disclosure to investors but is a compromise which we support as it is impracticable to force prospectus-type disclosure when only small amounts of securities are being sold. The actual numbers should be left to commission rule. Even for reporting issuers we do believe that, contrary to the proposed provisions in Ontario Bill 98, some number limitations should be retained in secondary distributions of this type.[386]

(4) The transactions must be completed in "broker transactions"[387] and the seller must not solicit any order to buy.[388] The prohibition on grooming the market seems particularly appropriate where no disclosure is to be provided and we would tentatively recommend its inclusion although we believe it should be the subject of continuing review. If our recommendation that reporting issuer securities be listed on a stock exchange becomes effective, it virtually assures that the transaction must be done through a broker.[389] For non-

384 There are aggregating provisions to cover spouses and family. In addition, for "affiliates" all sales are added in the six-month period whether or not acquired on a limited offering basis. For a good basic checklist *see* Levenson, *The SEC Approach to Rule 144*, 67 Nw. U.L. Rev. 164 (1972). In 1975, NASDAQ was added as an exchange for the purposes of number calculations under the rule. This was a relaxation for some issuers but a restriction for others as the test is on a "lesser of" basis.

385 A similar policy is used in Ontario on s. 59 applications where the commission only allows a resale in accordance with "orderly marketing" policies of the Toronto Stock Exchange; *see* OSC, Policy No. 3-18, *supra* note 286. The Toronto Stock Exchange requirements are decided on a case by case basis on the basis of the trading volume of the particular security involved and the likelihood that the shares affected by the order will be resold quickly. *See also* the discussion by Dey, *supra* note 247, at 172–73, of the "fur coat" exemption under s. 58(2)(c) of the present Ontario Securities Act. While this provision has been deleted, it should be stressed that s. 73(7) of Ontario Bill 98 allows a person who has a controlling position to sell all his securities without any restrictions if certain filings are made and the issuer is a reporting issuer.

386 Which would be consistent with the trading transaction exemption in ALI Federal Securities Code, Reporter's Revision of Tent. Drafts Nos. 1-3, s. 227(c)(1)(F).

387 This is also required under OSC, Policy No. 3-18, *supra* note 286.

388 *See* Miller & Setzer, *The SEC's New Rule 144*, 27 Bus. Law. 1047 (1972). The same idea of not creating a demand is found in Ontario Bill 98, s. 73(5)(c).

389 The only other likely agent would be a bank and Ontario Bill 98 would make them register unless they in turn act through a broker; *see* Ontario Bill 98, s. 35(1)10(b)

reporting issuers the broker assures a screen which should help to protect the purchaser. Thus we would support the broker requirement with respect to sales of securities of both reporting and non-reporting issuers.

(5) There are filing formalities to ensure that the central registry is kept up-to-date on what has been sold.[390] This is obviously a necessary requirement if any control is to remain over such resales at all.[391]

In short, our proposed resale exemption is wider than that proposed in Ontario Bill 98 but similar to the *ALI Federal Securities Code* although we believe the holding period is irrelevant so long as the numbers of purchasers or securities involved are limited on the resale. On the other hand, no length of holding period substitutes for adequate disclosure on the wide distribution of a large block of securities. It should be noted that this trading transaction exemption will only apply to reporting issuers as there will be no substantial market to allow a numbers test for non-reporting issuers.

Somewhat similar to the institutional or sophisticated purchaser concept but constituting an entirely different set of exemptions under provincial statutes are those which recognize certain classes of purchasers as in a special category so far as a given issuer is concerned. One such exemption, historically recognized in Canada but not in the United States,[392] is for a sale by an employer to employees of securities of the employer.[393] *The Ontario Securities Commission Disclosure Report* justified the continuation of the exemption on the basis that it is "desirable that employees should be readily permitted to invest in the company in which they are employed".[394] Certainly we would be loathe to see stock option or stock purchase plans disappear as a result of over-zealous regulation. But it would not be appropriate to place a substantial new offering entirely with employees. Such an occurrence is probably only theoretically possible in so far as stock option plans are concerned in view of the limits of the number of shares which can be under option pursuant to stock exchange rules. We believe that the employee exemption should be limited to some specific percentage of outstanding securities for situations other than stock option or stock purchase plans.

390 *See* Applebaum, *The Rule 144 Pattern – An Overview*, 67 Nw. U.L. Rev. 76 (1972); Bloomenthal, *Rule 144, the SEC, and Restricted Securities*, 49 Den. L.J. 301 (1973); *see also* Bialkin, *Rule 144 Amendments*, 8 Rev. Sec. Reg. 939 (April 26, 1974).

391 Reporting is also required under Ontario Bill 98, s. 73(4)(c).

392 *See* Dey, *supra* note 247, at 142, 162.

393 Ontario Securities Act, ss. 58(1)(c), 19(1)10. The exemption is limited to trades that are not induced by an expectation of employment.

394 Ontario Securities Commission Disclosure Report at 108. The exemption is carried forward in Ontario Bill 98, s. 73(1)(l).

The second group of exemptions for issuer placements to a specified group under current provincial legislation is the three exemptions for placements to existing shareholders, namely, stock dividends, securities issued on reorganizations and rights offerings.[395] These exemptions have been carried forward into Ontario Bill 98[396] substantially unamended. We know of very few problems[397] which have resulted as a consequence of these exemptions and we would recommend their retention as the number of times they are useful in reducing unnecessary regulatory activity far outweighs the problems they create.

Under the SEC statutes, there is an exemption from the registration requirements, for "transactions by an issuer not involving any public offering",[398] which was intended to allow issuers to avoid the substantial burdens of registration when the public was not involved. But the standards were vague and the risk of error, with possible attendant liability, has increased dramatically as the courts have become stricter over the years.[399] The SEC has tried to formulate various exemptions, none of which has met with much popular acclaim.[400] The current one is Rule 146 adopted in 1974.[401] The most significant concepts in the rule are that the purchasers must have access to the same kind of information that registration would disclose and they must have the ability to fend for themselves.[402] Thus this U.S. rule is really confined to the sophisticated purchaser whom we have discussed above.[403] The rule is replaced by the limited offering exemption in the *ALI Federal Securities Code* and we are proposing a similar exemption. It will allow some flexibility not only on sales of securities of

395 Ontario Securities Act, ss. 58(1)(c), 19(1)(8); Dey, *supra* note 247, at 153-58.

396 Ontario Bill 98, s. 73(1)(f).

397 *See In re* Panacea Mining & Exploration Ltd., [1971] OSC Bull. 156, 163 (October) for one situation which may indicate that problems can develop. In fact, in Ontario, the OSC has been insisting that any material change since the last notice to shareholders be communicated before a rights offering may be proceeded with. This has been a very salutary requirement.

398 Securities Act of 1933, s. 4(2).

399 *See* Patton, *Private Offerings: A Proposal for Administrative Action in Arizona*, 15 Ariz. L. Rev. 1 (1973).

400 *See, e.g., Rule 146 - Safe Harbor or Dry Dock for Private Placements*, 256 BNA Sec. Reg. & L. Rep., June 12, 1974, at B-1, where it is stated that "the route to that harbor is shallow and treacherous and the harbor itself is swept by dangerous currents".

401 Originally proposed in 1972, it was revised and republished in 1973 and adopted in 1974 pursuant to SEC, Securities Act of 1933 Release No. 5487, April 23, 1974, 4 SEC Docket 154 (No. 5, 1974); *see* Castruccio & Tischler, *supra* note 378, for details of changes in 1975.

402 *See* Wander & Shervitz, *Rule 146 Adopted*, 7 Rev. Sec. Reg. 911 (June 5, 1974). The "fend for themselves" test can be satisfied through our "offeree representative" who is a qualified adviser.

403 *See* Note, *The Private Offering: Rule 146 and Offeree Sophistication*, 25 Maine L. Rev. 295 (1973).

reporting issuers but also on both primary and secondary sales of non-reporting issuers.

While the United States does not have a general employee exemption, it does have exemptions for exchanges with shareholders in judicially or administratively approved transactions, on the exercise of conversion rights and for non-conversion exchanges.[404] There is also a proposed exemption in the *ALI Federal Securities Code*, not restricted to issuers, for all offerings under $100,000.[405] This latter exemption is, in our view, inconsistent with a comprehensive disclosure system although we realize that the cost of prospectus-type disclosure makes small offerings prohibitively expensive. Nevertheless, investor protection cannot be ignored and, if the public is to be solicited, some minimum standards should prevail on initial issues.[406] We would hope that a simplified form of prospectus could be developed on such offerings in an effort to cut the costs involved.

The third group of trading exemptions is really more related to marketing techniques than it is to any real exemption theory. Thus if the distribution goes down a chain from issuer to underwriter to banking group to selling group to customer, it would be useless to require a prospectus at each stage. What is desired is that the ultimate consumer be given a document he can understand and the investment analysts be given full information.[407] We have earlier commented that the satisfaction of prospectus requirements by delivery to an agent can be unsatisfactory and we adhere to that view. With that reservation we agree with a marketing exemption and we think the system proposed under Ontario Bill 98 is both simple and workable.[408]

Thus the major differences we suggest from the proposed Canadian provincial system for exemptions at the secondary distribution level are twofold. In the absence of market grooming, the proposed Ontario system never requires a prospectus if the issuer is a reporting issuer whereas we feel a prospectus should be required in the case of the public distribution of large blocks as

404 *See* ALI Federal Securities Code, Tent. Draft No. 1, at 108-14.

405 *Id.* s. 511(d). It cannot be used on a secondary distribution of securities sold under a limited offering.

406 Loss foresees a higher figure than the $100,000 being used on primary issues subject to a regulation "A" short form prospectus; *see id.* at 107.

407 This is presently done in Ontario by a peculiar definition of underwriter, partly copied from U.S. statutes where the system is quite different, coupled with an exemption for trades to or among underwriters; *see* Ontario Securities Act, ss. 58(1)(c), 19(1)6, 1(1)25. *See* Dey, *supra* note 247, at 151. For the proposed U.S. scheme *see* ALI Federal Securities Code, Reporter's Revision of Tent. Drafts Nos. 1-3, ss. 511(a), (b), (c), 512.

408 Ontario Bill 98, ss. 73(1)(o), 73(6).

discussed earlier.[409] We also believe that there must be some flexibility for the sale or resale of securities of non-reporting issuers. Contrary to Ontario Bill 98, we have suggested that an exemption based on the number of purchasers (up to thirty-five), regardless of sophistication, be permitted but only if the transactions are handled through licensed brokers and the number of shareholders does not fan out past thirty-five within three years of the sale or resale in question.

The proposed Ontario system also has an exemption for pledges of securities, held by persons whose holdings materially affect control, to secure a *bona fide* debt.[410] As we have no concept of control block distribution under our proposed system this exemption will not be necessary. A similar exemption for isolated trades out of a control block, which exists under the current provincial legislation,[411] can be ignored for the same reason.

Finally, so far as trading exemptions are concerned under Ontario law, there is an exemption for distributions of listed stock through the facilities of the Toronto Stock Exchange if a statement of material facts is accepted by the commission.[412] A statement of material facts is very similar to a prospectus in practice, although the sale price is not shown as it varies with the market.[413] From a disclosure point of view the real difference is in dissemination techniques. We do not believe that the disclosure is adequate if there is less dissemination than would occur with a prospectus. We doubt that adequate dissemination of information is likely to be possible in the hurly-burly of a busy day on the exchange[414] but we would note that investors seldom read prospectuses anyway and the deemed reliance provisions apply to statements of material facts. In practice the exemption has proved to be very useful and not abused. Accordingly we submit that this exemption, although theoretically objectionable, should remain unless, upon further study, it appears that the exception has negative factors of which we are not aware. Its central use has been for speculative mining companies[415] but it has been used

409 We have ignored in this paper the disclosure requirements of Ontario Bill 98, s. 73(5), because we feel the burden of such reporting should be on the issuer and should not be transferred to the reseller simply because of the desire to resell.

410 Ontario Bill 98, s. 73(e). Resales by the pledgee are subject to the same limitations as resales by the pledgor under s. 73(7).

411 Ontario Securities Act, s. 58(2)(c).

412 *Id.* s. 58(2)(b) which is carried forward into Ontario Bill 98, s. 74(1)(b). Québec has a similar exemption administratively invented; *see* 5 QSC Bull. No. 44 (November 5, 1974). *See* comments in text accompanying notes 213, 214 *supra*.

413 *See* Apple, *supra* note 295; Dey, *supra* note 247, at 171-72.

414 There is also the problem of divided regulation because of several stock exchanges; *see* Baillie, *supra* note 205, at 380.

415 *See* 3 R. Kingston, Ontario Corporation Manual 8276 (1978) ("Public Financing").

extensively in sales out of control blocks. We suggest that the "statement of material facts" be called a prospectus and that its ultimate delivery to each purchaser be required by the statute, although an interim delivery to the purchaser's agent should be maintained to permit the smaller brokers to participate in such distributions.

We have already dealt at some length with exemptions related to the type of security being sold. These are also discussed in Professor F. Iacobucci's paper in this volume, and we will not reconsider them here. One exemption which we have not covered and which has only recently been introduced in Canada is the exemption for puts and calls written by members of the stock exchange on securities listed on the exchanges.[416] A similar exemption was suggested in the first draft of the *ALI Federal Securities Code* but has now been watered down to allow the commission to withdraw the exemption.[417] An exemption is appropriate in our view only if the option market is directly regulated. Options are generally used by speculators trying to make a large profit at a low cost.[418] The risk to the unwary is considerable. If ever there was an area where trading should be confined strictly to informed investors the market in puts, calls, strips, straddles, spreads and straps is surely it, although we would support an exemption to allow the small investor to gamble a bit if he so desires. Securities regulation is not a morality code.

Chapter VII
Dissemination

The most complete disclosure is useless if it is hidden. Hiding can be done either by making the document unintelligible to the recipient or by not allowing it to reach any comprehending recipient. Seen in this light, the problem of dissemination can be seen as having two dimensions: (1) if the disclosure document talks with a confounding and confusion of tongues it is useless;[419] (2) if we are to have a sound capital market then the shareholders, brokers and financial experts must have access to full and reliable information.[420] Due in large part to technological breakthroughs in the compilation and dispensing of information through the use of

416 Ontario Securities Regulations, s. 86.

417 *See* ALI Federal Ssecurites Code, Reporter's Revision of Tent. Drafts Nos. 1-3, at 76.

418 *See* SEC, Report on Put and Call Options (1961).

419 A. Briloff, Unaccountable Accounting (1972); O'Neal & Schwartzberg, *Financial Disclosure - A Tool for Public Analysis*, 6 Transnat'l L.J. 1 (1974).

420 Re Castlereagh Securities, [1973] 1 N.S.W.R. 624 (Eq. Div.).

photography, computers and data-processing equipment that were unavailable one or two decades ago, the ready availability of corporate information is a reality.[421] Indeed the investor and the analyst may suffer from an informational overload,[422] sometimes purposefully supplied to hide pertinent information in the resulting morass. We believe that the purpose of a viable dissemination system is to provide recipients with as much as they need but not more than they can absorb.

Individual investors are, in large measure, financially well-to-do but unsophisticated members of society. Analysts, including those directing the portfolio investments of institutions, are sophisticated but not necessarily investors, at least for their own accounts. Thus we have the dichotomy of public disclosure, or at least public access to information, which is directed to two groups with divergent interests.[423] Insistence on uniform disclosure or disclosure documents of a type appropriate to 1844 when Gladstone introduced a general disclosure regime in England, is not necessarily consistent with current reality.[424] What is vitally needed is a separation of available disclosure for analysts through a central file or repository where all information, whether required by legislation or voluntarily divulged by an issuer, is open for inspection[425] and direct disclosure to shareholders and to the public of material information in a style acceptable to them. The latter objective is now served essentially by the annual report[426] although some commentators feel it will no longer serve the purpose if the SEC starts to dictate its contents.[427]

Our recommendation for reporting issuers would be to separate the two classes of recipients while at the same time having all information available. We will assume that the shareholders effectively include all interested members of the public so far as mandatory periodic disclosure is concerned. In fact, the cost of a single share is not high. Any interested person can buy one share and thus be sent annual and periodic reports, which reports we believe should be prepared at a relatively unsophisticated level. Such reports should be sent free of charge to all shareholders and copies

421 *See* WHEAT REPORT, ch. IX, for a discussion of the microfiche systems available in 1969 as an example of modern developments. Similar systems are presently available in Canada.

422 Knauss, *supra* note 83.

423 Duome, *The Two People Who Read Annual Reports*, [1974] INVESTMENT DEALERS DIGEST 14.

424 *See* Schneider, *Reform of the Federal Securities Laws*, 115 U. PA. L REV. 1023 (1967).

425 *See* SEC Proposes Firms Report to Agency Profit Forecasts Given to Analysts, The Wall Street Journal, April 29, 1975, at 2.

426 Sommer, *The Annual Report - A Prime Disclosure Document*, [1972] DUKE L.J. 1093, 1122.

427 Riggs, *Annual Shareholder Reports*, 7 REV. SEC. REG. 893 (August 14, 1974).

should be available at a minimal cost to any interested member of the public. The reports should include the disclosure requirements deemed necessary to show good corporate citizenship[428] as well as to give the reader some idea of the past performance of the enterprise over a fairly extended period, perhaps as much as five years. They should not be cluttered with voluminous financial statements or notes to financial statements. Auditors' reports should be designed to be explanatory, if they are included at all. The issuer should be free to include anything he desires in the various reports unless prohibited by commission rule. Compared with existing periodic reports, our recommendations would require less emphasis on formal financial statements.

Completing the publicly distributed material would be timely disclosure reports of material information which would be the subject of a press release but which would not be required to be sent to shareholders. Neither the periodic reports nor the timely disclosure releases would be checked by the commission although some civil liability should attach to misinformation or puffing contained in them. Soft data could only be included if consistent with rules adopted by the commission. Such a reporting framework would not have the information that a sophisticated investor or analyst would need but reference would be made to where that information was available.[429] Unlike the present system, the information distributed publicly by the issuer would not pretend to be useful for analysis because there would be little or no raw data.

For the interested investor, we believe that the central files at the securities commission and stock exchanges, which would eventually be on a microfiche or computer system, should be adequate. We see these files as being regularly updated and changes, which are not sufficiently material to justify a press release, would be available on a current basis. The central disclosure register would contain significant amounts of soft data. We see no need to burden the unsophisticated layman with data only the sophisticated can utilize effectively.[430]

We do believe that a broker who, in effect, solicits a client to purchase or sell a particular stock should be encouraged to send to

428 *See* Developing Trends in Company Law, address by H. Purdy Crawford, *ICSA Seminar* (June 18, 1975).

429 We recognize that this goes against the trend for including more sophisticated data in annual reports as suggested by several authorities in the United States; *see* Garrett, *The Role of Financial Public Relations*, [1974] INVESTMENT DEALERS DIG. ANN. REP. REV. 8; Gilbert, *The 10-K Report Now an Integral Part of Modern Reporting Standards*, *id.* at 18; Carlson, *Corporate Reporting - A Security Analyst's View*, FINANCIAL EXECUTIVE, May 1974, at 58; Cohen, *supra* note 141.

430 But the analyst clearly needs soft data such as value estimates, earnings projections, probable and potential minerals, *etc.*; *see* Kripke, *supra* note 128, at 637.

the client either the latest annual report of the issuer (where the client is purchasing) or photostats from the microfiche file that the broker feels the client could understand. An alternative might be to deliver a synopsis prepared by the broker.[431] We would recommend that the commission be given a discretion to require dissemination of such material by the broker where it believes there may be a problem of speculative trading and solicited orders.

Perhaps the most difficult question in dissemination techniques relates to the prospectus. If we concentrate on new issues, it is fair to say that the securities are often offered for sale before the prospectus has been received by the prospective purchasers. The *Wheat Report* and Ontario Bill 98 both support some effort to increase dissemination of information before the final prospectus is mailed. The *Wheat Report* details at some length the various attempts since 1933 to disseminate information to investors during the "waiting period", including "red herrings", "blue cards", "identifying statements" and "summary prospectuses". All of these attempts have failed. Until some new workable system is developed, we believe that the concept of mandatory dissemination of information during the waiting period should be abandoned. While retrospectuses are not as good as prospectuses in theory, they could be made more effective than they currently are. We believe that a more extended rescission period than presently exists, say, three or four days, might be feasible for purchasers of small amounts of the issue. For large purchasers or institutions there is no need for any rescission period as they are sophisticated purchasers and no prospectus would have been filed if the smaller investor had not been involved. A long rescission period would simply provide them with a free ride. But longer periods now exist in New York[432] and used to exist in Ontario[433] so they are not impossible for the brokerage community to live with. If the front page of the prospectus advised the purchaser of a three-day right of rescission for small investors and suggested he read the prospectus to see if he might like to exercise the right, the investor should be adequately protected without worrying about dissemination of information in the waiting period.

The prospectus should still be delivered to purchasers in accordance with existing practice. In the United States there is a "forty-day rule" which obliges dealers to send out a prospectus to all purchasers of securities of a reporting company that purchases

431 *See* WHEAT REPORT at 319.
432 *See id.* at 119.
433 *See* KIMBER REPORT.

within forty days of a new issue.[434] This system has been honoured mainly in the breach and is now being discarded.[435] But for new issues of non-reporting issuers there is a similar ninety-day rule which is being used now and the requirement will be strengthened under proposed legislation.[436] We recommend adoption of the ninety-day rule for initial issues by a previously non-reporting issuer.[437] We believe that a relatively small issue in a glamour industry needs far more dissemination of relevant information than an established public company.[438]

We have not canvassed the extra dissemination requirements on take-over bids or of insider trading reports, which are partly covered in other papers. We do wish to stress that such other disclosure requirements should be built into the system here proposed. Thus insider trading reports should not be published in some weekly or monthly bulletin but should be in the central file. On the other hand takeover bid circulars should be widely disseminated.

Chapter VIII
Summary of Recommendations

It is not necessary to restate all our recommendations in detail but we believe it may prove useful to have a summary of them readily available. We would stress again that the basic assumptions set out in chapter VI.A. have had a significant influence on the formulation of these proposals. In addition, all of our recommendations are qualified by our belief that compatibility with the existing provincial regulatory systems is essential. To the extent that any of the assumptions set out in chapter VI are incorrect, or if the provinces are unwilling to adjust their own legislation to ensure compatibility with the proposed system then the implementation of our proposals should be reconsidered.

A. CONTINUOUS DISCLOSURE

This would be required only of reporting issuers which would be defined to mean:

(1) A corporation with over 300 public holders of its equity securities, including as "equity securities" any security convertible

434 The rule only applies if the securities are derived from the new issue.

435 *See* WHEAT REPORT at 121.

436 *See id.* at 123; ALI FEDERAL SECURITIES CODE, Tent. Draft No. 1, ss. 511(b), (c).

437 The rescission rights usually connected with prospectus delivery in Canada should not apply to secondary trades during this 90-day period.

438 *See* Bromberg, *supra* note 142, at 1175.

into such a security or carrying a right to subscribe to such a security. Excluded from "public holders" would be any directors, officers or holders of more than 10% of any class of securities of the issuer involved together with their associates. Consideration should be given to requiring such corporations to list on a recognized stock exchange once the necessary facilities to accommodate such listing have been put in place and the regulatory difficulties satisfactorily resolved.

(2) A corporation which does not satisfy the tests under (1) above but which the commission permits to become a reporting issuer upon application of such corporation. The commission, in considering such application, would consider whether there was sufficient interest in the corporation to ensure that financial analysts would continue to follow it.

(3) A corporation with over 300 holders of its debt securities where the commission specifically required it to become a reporting issuer.

Excluded from reporting issuer status would be:

(1) charities, social clubs and similar not-for-profit institutions;

(2) regulated industries where the regulation assured comparable public disclosure of information as would be required under the federal securities legislation;

(3) mutual insurance companies or any similar institutions where there are no easily transferable interests;

(4) corporations exempted from reporting issuer requirements by the commission, after a hearing.

Generally, corporations which had been "reporting issuers" for over twelve months in Ontario, or other provinces having similar requirements, would automatically obtain status on filing the required documentation if they also satisfied the 300 public shareholders requirement. All other corporations would be screened by the commission before becoming reporting issuers. It would be the responsibility of the commission to ensure that the corporations voluntarily seeking to become reporting issuers were suitable to be granted reporting issuer status.

A reporting issuer would:

(1) File an initial registration statement with the commission and, once the stock exchanges had facilities to handle the information, with the stock exchanges and perhaps with the IDA. The contents of the registration statement would be set forth in rules promulgated by the commission and would permit the inclusion of a considerable amount of "soft data". This registration statement would be kept up-to-date at all times by the reporting issuer and would be available to the public.

(2) Regularly report to its shareholders, at least semi-annually and likely quarterly, in a narrative form. The commission rules would specify some required data but not extensive financial statements. The issuer would be free to include other data except data specifically prohibited by commission rules. The periodic reports would include any material information now contained in information circulars or like documents. The periodic reports would not be precleared with the commission.
(3) Disclose as soon as reasonably possible all material changes relating to the corporation through press releases. Where the issuer believed that material information was confidential a notice that confidential information existed would be filed with the commission but the information itself would not be filed. This would allow the commission to watch trading activity in the stock while preserving the confidentiality which is so essential to the issuer.

Reporting issuers would be the only entities whose shares could be widely traded in the secondary markets, except with the specific blessing of the commission. Generally speaking, reporting issuers would be allowed to sell new issues of securities pursuant to summary prospectuses as opposed to full prospectus disclosure.

B. PROSPECTUS DISCLOSURE

Prospectus disclosure of the type now common across Canada would continue to be required on all new issues of securities, not otherwise exempt, although the commission rules would provide for a summary prospectus for use by reporting issuers whose securities were regularly followed by financial analysts. The present requirement of a mandatory preliminary prospectus would be dropped. A slightly longer rescission period after receipt of the prospectus for small purchasers should be considered.

The contents of the prospectus would not be set forth in the statute at all but would be left entirely to commission rules. There would be no requirement for a certificate by the issuer or underwriter as to completeness in the publicly distributed copies of the prospectus nor would a legend indicating that the securities commission had not considered the merits of the offering be included. Different requirements for different types of issuers would be set forth in the rules. Soft data would generally be prohibited from disclosure in the prospectus.

The commission would have a discretion to reject a prospectus where it felt the securities offered were unsuitable for investment by the general public. The commission would be encouraged to concentrate on new issues by unknown entities and on issues

meriting special attention for other reasons, for example, because the issuer had a high debt equity ratio. The commission would not be expected to even check the prospectus of a well-established and stable reporting issuer unless it desired to do so.

In addition to requiring prospectuses on new issues by an issuer, a prospectus would be required on secondary issues, whether or not emanating from a control block, where the seller sold in excess of a stipulated amount of securities to the public. Before this proposal is implemented with respect to reporting issuers however the commission must be assured that it will have no material impact on institutional investors. If it is implemented, the stipulated amount should be related to the traded volume of the security, perhaps 1% of the average monthly traded volume over the past three months. This figure would be set by commission rule and the commission could relax the rule upon application in any particular case. Special provision might be made so that the commission could require a prospectus filing in other situations, for example, if the trading volume at any time increased dramatically in the securities of a particular issuer. However, care should be taken to avoid a compulsion to disclose confidential information when the issuer has no control over the timing of the filing, unless the information has already "leaked".

C. EXEMPTIONS FROM PROSPECTUS REQUIREMENTS

There should continue to be exemptions from prospectus requirements based on the status of the issuer but these should be confined to:

(1) Canadian government issues, including municipal bonds issued by municipalities in Canada and any other issues that the government has obligated itself to exempt under a treaty or international agreement;
(2) regulated industries where the disclosure demanded by the regulatory authority is equally as pervasive as that required under the federal securities legislation;
(3) not-for-profit corporations such as charities and social clubs;
(4) any issue where the total number of owners of equity securities of the issuer will be less than fifty after the issue has taken place.

The existing provincial exemptions based on the type of security being issued should be retained, namely:

(1) short-term debt sold in denominations in excess of $50,000 or whatever higher figure the commission designates by rule;
(2) mortgages sold by a registered mortgage broker, at least

until a trading market in mortgages becomes more widely established;

(3) conditional sales contracts not offered for sale to the public.

There should be whatever exemptions are necessary for trades between underwriters or between brokers so long as the ultimate purchaser on a public distribution receives the prospectus. The scope of this exemption must be kept under continuous review to ensure that it is neither so wide as to permit evasion of the prospectus delivery requirements nor so narrow as to hinder legitimate marketing practices.

There would be three major exemptions that would apply on both primary and secondary distributions:

(1) sales to up to one hundred sophisticated purchasers on any issue or distribution;

(2) sales limited to a determinate number of securities over a given time span, such number to be fixed by the commission but likely based on a percentage of the average traded volume; this exemption would only apply to reporting issuers;

(3) a distribution to less than thirty-five persons which did not fan out to more than thirty-five persons over a three-year period; this exemption would only apply to non-reporting issuers.

These exemptions would both be available to the issuer and to vendors in the secondary market. Sophisticated purchasers would include the financial institutions and persons purchasing in excess of $100,000 blocks.

Other more minor exemptions would include:

(1) sales to employees by an issuer, within limits as to total volume during any twelve-month period;

(2) sales to existing security holders through stock dividends, reorganizations and rights offerings;

(3) exchanges made as a result of asset acquisitions, amalgamations and share for share exchanges, subject to the takeover bid disclosure requirements.

Finally we would retain the exemption for sales made on the stock exchange where a statement of material facts is delivered to the purchaser, but the commission should have specific power to withdraw the exemption with respect to any issue if it is being used to distribute large blocks to the public without adequate information reaching the investor.

D. DISSEMINATION

We have recommended that the periodic disclosure reports to shareholders form the basis of public disclosure in the general

sense. These reports would be supplemented by timely disclosure through press releases. These reports and releases would not be technical at all, would not be precleared by the commission and would permit the issuer to include data he believed to be relevant subject only to specific prohibitions.

For reporting issuers, a detailed registration statement, kept current by the issuer, would be available to analysts and other interested members of the public at the commission offices. The stock exchanges would be encouraged to develop a system so that copies of the registration statement filed with the exchanges would be available to exchange members by a microfiche or computer system. Until such a system is developed there is little point in requiring that copies be filed with the exchanges. Once such a system is developed brokers who solicit orders from clients should have an obligation to send to their clients such information as they think the client needs to assess his proposed investment. This would be an extension of the presently existing "know-your-client" rules. We believe it should be developed slowly so costly systems of little practical use are avoided.

Continuing Disclosure and Data Collection

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Chapter I
Introduction

The economic role of government is to manage the economy, maintain a high level of employment, control inflation and promote economic growth. To meet this challenge, the government must have comprehensive information on business enterprises so that it can forecast trends, plan and predict the outcome of its programs. In the past – and indeed present – these information needs have been wanting. To fill the void, government often resorted to the establishment of commissions, such as the Royal Commission on Corporate Concentration and the Royal Commission on Government Organization, or to ad hoc committees such as the Interdepartmental Committee on Data Collection and Inspection Activities. However, neither Royal Commissions nor ad hoc committees can satisfy the continuing information needs of government, and as a result a substantial amount of data collection occurs on a regular basis in government departments. To improve the timeliness and quality of information, while at the same time reducing the burden on respondents, a rational approach must be sought to coordinate the gathering and dissemination of information, the sharing and transferring information among government departments and the eventual integration of databanks.

The views expressed in this paper are those of the author and do not necessarily reflect those of Consumer and Corporate Affairs Canada or its staff.

The continuous disclosure concept as outlined by Grover and Baillie in this volume[1] could provide the catalyst to bring the requirements of the private and public information disclosure systems into harmony with each other. Currently, the way in which the private sector prepares its financial statements and other corporate data is often different from the way in which government would like to have the data reported. There are, of course, exceptions, such as the returns filed under the Income Tax Act and filings by firms incorporated under the Canada Business Corporations Act. It could serve the interests of both the private sector and the government to have a common system for collection and dissemination of information.

Furthermore, a disclosure code should be established to make all material facts, subject to necessary exemptions, available in a common format. The Bank of America recently adopted a voluntary disclosure code which could be a model for the private sector. The objectives of the BankAmerica code are:

> "(1) to provide the men and women who manage BankAmerica with a continuing guide that keeps effective disclosure a principal objective of corporate policy;
> "(2) to facilitate disclosure of information that has been determined, not by the corporation but by its constituencies, to be useful and relevant in understanding and evaluating BankAmerica's activities;
> "(3) to encourage disclosure of information in ways which can be easily understood by all concerned;
> "(4) to give the public ready access, to the extent permitted by law, to information the corporation currently provides in its routine reporting to regulatory agencies;
> "(5) to define the limits of voluntary disclosure – that is, to respond to the public's question, 'why not?'."[2]

The government, for its part, must recognize that there are inefficiencies and waste in its information collection process which result in unnecessary duplication in forms and time pressures on those required to respond to them. Credibility of government information is especially open to challenge when its programs or decision-making are delayed by a lack of information or by misinformation. It is therefore necessary to reorganize and modernize the government's machinery for collecting and disseminating corporate information.

Following is a review of the government information collection process and how this process can be improved for the benefit

1 *See generally, Grover & Baillie, Disclosure.*
2 BankAmerica Corporation, *Voluntary Disclosure Code*, 95 BANKING L.J. 4, 5 (1978).

of the public and private sectors, in the light of a continuous disclosure system developed under modern securities legislation.

Chapter II
Government Data Collection

There is an abundance of corporate information within the many federal government departments and agencies: large amounts of corporate data are deposited with regulatory departments to meet administrative requirements and smaller amounts are collected by surveys.

Difficulties derive not from the amount of information but from the lack of human communications skills to coordinate the collection process and to document, and ultimately interpret, the total inflow of information. In order to devise an adequate system, it is necessary to develop an inventory system to describe the type of information being collected and its availability, the collecting departments, frequency of collection and timeliness, confidentiality restraints, definitional standards and time frames. The absence of such a system continues to frustrate persons from whom information is required. The duplication of requests from many government departments results in unnecessary human and financial costs.

The absence of such an information system is the result of both the statutes authorizing the collection of information – for example, the Statistics Act[3] – and their administration. The statutes, in effect, often require duplicate facilities for the collection and storage even of tombstone data by specifying that the information is confidential and cannot be disclosed even to other government departments. Simultaneously, perhaps partly as a result, there has been a failure of government departments to coordinate their collection of information and thus ease the burden imposed on those supplying the data.

The Royal Commission on Government Organization, the Glassco Commission, in its report in 1962 confirmed the existence of the above problems and recommended measures to eliminate them. The Treasury Board responded to these recommendations and in 1966 promulgated a policy aimed at reducing the response burden and eliminating duplication.[4] The policy required all departments and agencies requesting information from more than ten respondents to provide the Chief Statistician of Canada with

3 Statistics Act, R.S.C. 1970, c. S-16, *as amended.*

4 *See* Management Improvement Policy, T.B. No. 659860 (September 8, 1966); M1-11-66 (September 12, 1966) (Treasury Board Circular Letter covering requests for information from more than ten respondents).

copies of the requests and all accompanying forms, schedules and questionnaires before the proposed survey date.[5]

However well intentioned, the policy was ineffective for basically the same reasons experienced in the United States under the Federal Reports Act of 1942.[6] That is, in many instances private firms or consultants were used to obtain the data.

There are approximately one hundred federal departments and agencies, not including autonomous operating units such as Air Canada and the Canadian National Railways, that collect data for administrative and regulatory purposes on a monthly, quarterly, semi-annual, annual and occasionally daily basis. There are about one million reporting firms in Canada, each of which could be simultaneously filing similar information with one or several administrative regulatory and/or statistical agencies, not including the information in their tax returns. Such duplicative requirements may create a formidable burden, especially for corporations which disclose similar data to provincial, municipal and other regulatory agencies such as securities commissions and stock exchanges.

We are concerned only with corporate data here, which is for the most part financial. There is minimal sharing and exchanging of data among government collectors. Furthermore, the material collected is not uniformly stored. It often remains on the original survey forms; some may be identified by a coding system peculiar to a particular branch or department and a small quantity may be put into machine-readable form. The government's lack of an efficient method and a proper facility for cataloguing and maintaining an inventory of corporate data often leads departments that are anxious to obtain information to collect the same data from essentially the same respondents. This embitters many corporations.

When corporations file data with government many of them believe it will be shared among departments; when they learn the contrary is true, they become dissatisfied and eventually antagonistic. Federal government collectors of information are often not sensitive to these feelings or even, on occasion, to their own data needs. As Professor Finagle[7] stated in his law of information:

(1) the information we have is not what we want;
(2) the information we want is not what we need;

5 *See id.*

6 *See* text accompanying and following note 8 *infra*.

7 Hunt, *Funds Position: Keystone in Financial Planning*, 53 HARV. BUS. REV. No. 3, 106-15 (1975).

(3) the information we need is not available.

And to use the words of Walt Kelly's comic-strip character, Pogo, "We have met the enemy and the enemy is us".

Data collected and compiled by special groups such as the Anti-Inflation Board and the Royal Commission on Corporate Concentration often lies dormant and/or is stored in the National Archives when the commission's mandate is completed. Special commissions leave a legacy of potentially meaningful data which is not incorporated into their reports and is therefore not available to anyone. It is unfortunate that the majority of specialists working on these commissions have never recommended a system which could be the nucleus of a government-wide data documentation centre for the continuous collection of needed information.

Chapter III
Means of Collection

Most data needs of government departments and agencies are met through their own administrative forms. Some information – on salaries, for example – is received from large employers on computer tapes. Most federal government departments have a surveillance system to ensure that all required data has been supplied and also to prod delinquent filers or to identify habitual violators who may be prosecuted.

Some surveys are used primarily to collect specific information for certain specified purposes. Once this data is used it is stored, and access to it is difficult. In 1966, in an effort to reduce the number of such surveys by government departments, Treasury Board invoked the rule of ten, mentioned above.[8] This rule stipulates that if more than ten respondents are to be surveyed, the form, purpose and type of data requested must be cleared by Statistics Canada, with Treasury Board being the final arbiter in the event of a disagreement.

The rule was based on one formulated by the United States Federal Paperwork Committee in 1942 under the Federal Report Act of 1942, the primary mechanism of the U.S. government for controlling its paper burden. However, the 1942 act was not completely effective because of structural and procedural flaws in the clearance process it had established, and the Commission on Federal Paperwork was set up to identify the defects and to recommend methods of rectifying them. One of the most important recommendations was that responsibility for coordinating the collection of information for program areas where several agen-

8 *See* materials in note 4 *supra*.

cies require similar information be assigned to a single "focal" agency. In 1974, therefore, the Office of Management and Budget and the General Accounting Office were given responsibility for reviewing and approving or rejecting proposed collection of information from the public by federal agencies.

In Canada, the effectiveness of the rule of ten was minimal because it was easily circumvented. Private agencies were hired to prepare the surveys or to undertake a broader project of which the survey formed an integral part. Departments were able to avoid the rule by characterizing the desired information as administrative rather than survey data. They succeeded in their efforts because of their autonomous nature and because no controlling or coordinating unit was established with the necessary enforcement powers. Statistics Canada, not having such authority, could only use persuasion. And while Treasury Board could restrict funds for departments not following established guidelines when the legislation defining a department's role gave it authority to collect the information, it was difficult to prevent it from carrying out its mandate. Until a unit with controlling, coordinating and disallowance powers is established, the effectiveness of present rules will continue to be limited.

Much of the data collected by governments and their agencies is classified as confidential by statutes such as the Statistics Act, by departmental policy or by a verbal undertaking given by the collecting authority to the effect that data on many industrial sectors is to be available only in aggregate form. This approach would be satisfactory if macroeconomic issues alone were involved. But there is also a substantial current need for microdata and more specifically for data on individual firms. Data in specific areas such as transfer pricing, profits by product lines and by operation, competition and concentration within an industry group are vital for policy development. And it is precisely this data that is not available to the public. Even though Canadians foot the collection bill, they can get little information about the specific activities of individual companies.

In order to obtain information on the actual operation of corporations subject to federal jurisdiction, the Canada Business Corporations Act recommends that such corporations indicate on the basis of the Standard Industrial Classification code[9] the industry sector in which their activities are conducted and identify sectors contributing 10% or more toward their profit in the same manner. This type of information is also required by the U.S.

9 Statistics Canada, Standard Industrial Classification Manual (Revised 1970) (Cat. No. 12-501, occasional publication).

Securities and Exchange Commission in its 10-K filings.[10] However, there has been little analysis to verify the accuracy of the information disclosed and no remedial actions have been taken in either country since the inception of the requirement.

The United States Federal Trade Commission, whose efforts in 1960 to collect refined corporate data by line of business failed, made a further effort to do so in 1974. As before, the issue was not resolved and went before the courts, with a ruling in favour of the FTC in 1978. The commission had given an undertaking that the data would not be divulged on an individual company basis and that access to the information would be limited to the staff of the Division of Financial Statistics.[11]

Chapter IV
Timeliness and Availability of Data

The collection, analysis and verification of data is a lengthy process which causes a delay in publication of from three months to three years. This makes the data of little current value. The publication in 1978 of information on intercorporate ownership compiled from data received as of 1975 under the Corporations and Labour Unions Returns Act (CALURA) while a valuable document is well out of date;[12] the rapidity of takeovers and mergers and the shifting of locations render the published data obsolete. A good deal of the delay is due to the verification that is conducted because of the statutory confidentiality provision.[13] In other cases, delays may be a result of the absence of material information which must be imputed, and care must be taken not to produce any inaccuracies or biases in the results. In fairness to the collectors, the delays are not entirely of their making: respondents' tardiness in transmitting the data is also a factor.

Rather than using precious time imputing missing data and checking statutory restrictions, government collectors should look at alternative, reliable sources of data. Similar data may be deposited under the disclosure provisions of the various securities commissions and stock exchanges or other private databanks such as the Financial Research Institute, Financial Post, Dun & Bradstreet or Canadian Business Service. Most information of this sort is in the public domain and is available without the usual govern-

10 Securities Exchange Act, 1934, ss. 13, 15(d) (annual filing).

11 *See, FTC's Authority on Business Data Upheld by Court,* The Wall Street Journal, July 11, 1978, at 3, col. 1.

12 Statistics Canada, Inter-Corporate Ownership (1978) (2 vols., Cat. No. 61-517, occasional publication).

13 Statistics Act, R.S.C. 1970, c. S-16, *as amended.*

ment confidentiality restrictions or delays. Furthermore, the data from these sources is more current, more complete and probably more accurate than that in government surveys because uniform data definitions are used and the reporting guidelines set out by the Canadian Institute of Chartered Accountants, the securities commissions, and the stock exchanges are followed. Information from these sources is filed by individual companies and thus provides a better basis for analysis and interpretation. More importantly, it is required on a continuing basis which ensures ready access; current revisions can be made.

During the past several years, there has been an increasing use by both the Canadian government and the private sector of the annual 10-K return which is filed with the Securities and Exchange Commission in Washington. Approximately 3,000 companies file these annual returns, among them about 150 Canadian corporations. A 10-K report contains full information on the nature of the filing corporation's business, its subsidiary companies, any important pending legal proceedings or contracts, as well as detailed annual financial statements. The information in the annual filing is supplemented by disclosures in the annual proxy statement and by quarterly and semi-annual filings and timely releases of important information. As a result, the Securities and Exchange Commission's files and even the 10-K report itself contain more information on filing corporations than is available elsewhere. Thus, Canadian corporations file more complete information in Washington than with any Canadian agency.

The ideal method of coordinating the collection of corporate information in Canada would be to harmonize the disclosure requirements of the corporate and securities laws with those under the Corporations and Labour Unions Returns Act.[14] This solution, even if imposed only by the federal government for its own purposes, would reduce the need for multiple filing of information as well as the cost of collection. However, proposed amendments to the act would remove most corporations now reporting from its coverage with the result that its effectiveness as a coordinating vehicle would be diminished.[15] In any event, all information disclosed under the act, other than tombstone data, is treated confidentially because the present form permits the use of tax data by respondents. In short, the potential of the Corporations and Labour Unions Returns Act as a vehicle for avoiding duplicate reporting has been negated by the confidential treatment of the

14 Corporations and Labour Unions Returns Act, R.S.C. 1970, c. C-31.

15 *See* Annual Return of Corporations, Sections A and B required under Corporations and Labour Unions Returns Act, pt. I.

information disclosed and will be further diminished by the proposed amendments to the act.

Chapter V
Duplication

Government departments have been criticized in Royal Commission reports[16] and by industry and industry spokesmen – such as the Committee of Independent Businessmen – about the duplication of data-gathering activities among departments. There are basically two types of duplication: for purposes of this paper they may be identified as *real* and *apparent*. Real duplication exists when two or more units within the same department or when two or more departments collect from the same respondent identical data for the same time frame using similar data definitions. Apparent duplication obtains for all other situations. Respondents do not distinguish between apparent and real duplication; they review requests for information on the basis of the cost and time necessary to provide it.

Nevertheless, there are some instances in which a case may be made for duplication. For example, both the Department of Industry, Trade and Commerce, and Statistics Canada collect information on "current capital expenditures"; the former requires the items as a bench mark or control figure within a space of time that is too short to permit Statistics Canada to make them available.

Other examples may be found in the area of labour statistics and mineral exploration. Several surveys, called "information on wages", and "the concept of wages", have varied with the collector. One survey requests gross wages, while another requests information on wages less specified deductions but including certain fringe benefits; yet another requests net wages. However, requests for confusingly similar data are likely to anger respondents. Moreover, the figures given to the various collectors probably come from the same source and are thus likely to be identical. In a 1977 article, W.H. Laughlin stated that a major form concerning exploration development and capital repair expenditures "is designed to accommodate twenty separate types of numerical data dealing solely with mineral exploration. Of these, only two are eventually published, partly because computation of the remainder is made meaningless by inconsistencies and omissions."[17]

16 *See e.g.* 3 Report of the Royal Commission on Government Organization 21-114 (Ottawa, 1962) (Supplying Services for Government: Report No. 12, Economic and Statistical Services and Report No. 13, Public Information Services).

17 Laughlin, *Exploration Activity Indicators Found Wanting*, The Northern Miner (Toronto), November 24, 1977, at D12.

There are also surveys that demand very refined data. These surveys, while not duplicative, impose a severe burden on the respondent. In some instances the respondent is unable to provide the data, and even if it were supplied, it would be of questionable value. The Computer Services Survey of Statistics Canada, for example, requires information available only from a highly sophisticated accounting system; in fact, each respondent is required to classify services of revenue by sixteen industry breakdowns.[18]

While demands for specific data items as outlined above may be legitimate from the surveyors' point of view, respondents may still regard them as duplication. A federal interdepartmental study in 1974 found that 188 surveys collected similar business data. If these demands could be integrated the required data might be made available to all.[19]

Continuing monthly and quarterly surveys should also be reviewed to see whether they continue to serve any purpose. It may be possible, for example, to reduce their frequency so that the monthly surveys might be taken on a quarterly basis and the quarterly ones only twice a year. Time series have been developed and analyses made by Statistics Canada to measure possible interruptions. At the same time, demands for more information are made. Experience in the United States indicates that demand has grown geometrically over the past two decades. It is estimated that it costs $43 billion a year for the collection and distribution of continuing survey data.[20] Comparable figures are not available for Canada, but the Glassco Commission report[21] estimated that about $20 million was spent in 1961 by the federal government to employ 3,000 persons to do statistical work and economic analysis, about two-thirds of which was incurred in respect of the statistical system.

If measures were taken by the federal government to implement the types of changes suggested in the preceding paragraph, they would go far toward assuaging businessmen who believe that the present requirements impose an unnecessary burden on them. The long-term benefits of such an attempt might lead to improvements in the quality of data received and thus to a more accurate and reliable reading of the health of the economy as well as resulting in cost savings for both the private and public sectors.

18 Interdepartmental Committee on Data Collection, Report of Working Group (Ottawa, 1973).

19 *See* app. B *infra* for table.

20 Commission on Federal Paperwork, Final Summary Report 5 (October 1977) (U.S. Government Printing Office).

21 3 Report of the Royal Commission on Government Organization, *supra* note 16, at 21.

Chapter VI
The Business Register

Throughout this paper, reference is made to the creation of a mechanism that would facilitate coordination of data collection and standardize the varied forms of data collected. A computerized facility to collect, convert, store and retrieve data from a base with uniform entity classifications, data organizations and coding keys might provide such a mechanism. A facility of this kind could permit access to and distribution of accurate and timely information. The organization housing it could be called a business register, data clearinghouse or whatever; this writer prefers the former. The fundamental purpose of a business register is to have readily available a complete up-to-date list of corporations operating in Canada with their addresses, type of business, capitalization, subsidiaries and the names and nationalities of their officers and directors. Financial and other data could easily be added to such a file once it has been established.

Statistics Canada has been attempting to establish a business register for many years. In doing so, some insurmountable problems have arisen. For example, it is extremely difficult to develop an accurate list to keep the file of business establishments current. In addition, data cannot be obtained from the tax files of Revenue Canada. Although Revenue Canada at one point opened its files to Statistics Canada, it later withdrew the privilege because the latter shared data with Consumer and Corporate Affairs Canada, which was itself developing a comprehensive list of corporate names. As a result, the development of a business register by Statistics Canada has been delayed. The project is now being reviewed, however, because of the interest of a number of departments.

A business register should contain tombstone data on a universal basis and should also identify and standardize other data elements that are frequently required to be disclosed by business enterprises. This exercise would involve a number of steps, namely:

(1) a listing of all existing government surveys and their objects updated annually and including their data specifications;
(2) a scale indicating the reliability of the information in the various sets;
(3) a dictionary of uniform statistical concepts and data elements;
(4) classification of business firms in a uniform fashion in a system which takes into account parent-subsidiary and similar relationships;

(5) establishment of uniform concepts as to time frames and monetary or other quantitative measurements;
(6) development and utilization of uniform steps in collecting data;
(7) development and eventual use of uniform data-processing standards to facilitate data transfers;
(8) development of more uniform source document standards;
(9) establishment of confidentiality standards especially with respect to:
    (a) the nature of data;
    (b) the type of entity (individual, unincorporated business firms, corporation);
    (c) the status of the user (private or public sector).

Given the need for a business register, the question of how to create one that can accomplish the desired goals remains. As long as the Statistics Act precludes the dissemination of detailed information, that is, microdata, Statistics Canada will be unable to perform all of the functions required of a business register. For example, information that is publicly available under the corporations and securities laws will not be disclosed in disaggregated form by Statistics Canada even when it has been received from a department that does disclose it. As a result, individual departments have developed their own information systems which they are reluctant to change.

In this context, the optimum solution would be establishment of a small coordinating agency responsible to Parliament through a Minister, presumably the Secretary of the Treasury Board, or to an independent review body. Such an agency could be empowered to transfer data-collection activities from one department to another in order to avoid duplication and to require transfer of the information collected to other users within the government. It would also diminish unnecessary effort by reviewing all surveys (and forms) and cancelling those that are unnecessary. And these functions would enable it to serve as a clearinghouse for information within the government.

A business register provides a basis for an efficient information system, especially if controlled by a coordinating agency like that suggested. Such a dual system will permit identification and analysis of the costs of gathering data and will also facilitate the use of alternative sources of information such as securities commissions and stock exchanges which already administer a system of continuous disclosure.[22] In addition, it will enable establishment and maintenance of an inventory of data that would provide a

22 *See generally, Grover & Baillie.*

basis for policy analysis of various kinds, while integrating existing databanks and reducing the costs of collection both to users and to those surveyed.

Chapter VII
Continuous Disclosure

The concept of continuous disclosure involves the availability of up-to-date information on corporations which have issued securities that are publicly traded.[23] The information that is filed and open to the public usually consists of annual and quarterly financial statements, all information circulars sent to shareholders and releases of timely information which may have an effect on the corporation. A system of continuous disclosure would go a long way toward improving the quality of information because of the generally accepted principles in accordance with which such information is prepared[24] and because of its timeliness. Such a system would also involve less cost to disclosing corporations.

A continuous disclosure system would not, alone, satisfy all government needs for information. Corporations and unincorporated business enterprises that have not issued securities to the public are not subject to the regular reporting requirements of corporation and securities laws, so that methods of obtaining information about them would have to exist alongside the more formal reporting system. However, such a system would complement the other methods and could result in a reduction of cost and enhancement of the general quality of information collected by the government by coordinating the information filed with securities commissions with that collected by other government agencies. The coordinating agency suggested above could establish mechanisms to accomplish these ends.

A coordinating agency could correlate not only the information collected by government agencies but also that gathered by private sources such as Dun & Bradstreet and the Financial Post and could store the data in machine-readable form permitting access through remote terminals by government officials, industry or academics. Special coding might be used to ensure that confidential information is available only to those entitled to it. Such a system would not only reduce duplication, but would also improve the quality and availability of corporate data and thus would both facilitate the development of government policy and

23 *See generally id.*
24 *See* Canadian Institute of Chartered Accountants, Handbook (1978).

further the aims of the continuous disclosure system for public issuers.[25]

Provincial governments, too, face similar problems in their collection of information. In fact, Québec has recognized the importance of a central registry of business firms and authorized the creation of the Fichier central des entreprises, a computerized system containing tombstone data such as the legal name of a firm carrying on business in Québec, the place and type of incorporation, location of head office, capitalization, nature and place of business and names and addresses of officers and directors. This data is updated annually from coded annual returns which are easily and efficiently fed into the computer, and inquiries to the Fichier central receive prompt responses. The Fichier central performs several types of service:

(1) it provides tombstone data by directly accessing the data-bank;[26]
(2) if such data is not available it directs the query to the department housing the data;
(3) it provides the source of the data to which the caller can direct his query.

Although there have been difficulties in establishing a similar system in the federal government, discussions on the feasibility of a centralized computer facility to house a business registry are continuing. It is somewhat discomfiting that better data than can be obtained in Canada on approximately 150 of the largest Canadian corporations is available from the Securities and Exchange Commission in Washington, D.C., and that the commission makes it available on microfiche, tape, or in hard copy.

The United States Federal Reserve Board uses data generated by the Securities and Exchange Commission for its quarterly report on the 200 largest manufacturing corporations which account for some 45% of sales, 60% of profits and 50% of all the assets of all U.S. corporations.

A federal body responsible for the supervision of the Canadian securities market would presumably collect information similar to that filed with the SEC. Such a body could, therefore, perform a similar function and provide an excellent source of micro-information on Canadian public issuers which could easily be integrated into a computerized facility for the storage and dissemination of business data.

25 *See generally id.*

26 Consumer and Corporate Affairs Canada has developed an information bank called CORBASE which performs the same functions.

Chapter VIII
Conclusion

Over the past several years, current information about the many segments of the Canadian economy – such as manufacturing, natural resources and ownership of the private sector – has been difficult to obtain. The difficulties arise from the incremental way in which the government information system developed; information was collected to meet the requirements of a specific program and not for overall government or business needs. No conscious attempt was made to coordinate data collection nor were there any efforts to reduce the burden on persons surveyed. The lack of coordination resulted in duplication of data collection, under-utilization of data collected, increased costs in human and financial terms and delays in processing and in disseminating data to the ultimate users.

The need to coordinate data collection activities is emphasized in a U.S. government report entitled *Federal Statistics*.[27] It is also essential, however, that the data thus collected be complete and accurate. To achieve accuracy, it is necessary to establish standardization in data reporting and collection. In the private sector, standards for financial reporting are set by the Canadian Institute of Chartered Accountants (CICA). No similar guidelines exist for the federal government's collectors of information. A government agency may therefore request data that is different from that normally prepared by a corporation. It would be beneficial if the government were to implement the guidelines adopted for business by the CICA. Once uniform reporting standards for both the private and public sectors have been adopted, coordination of the collection, processing and dissemination of information should follow. A centralized agency controlling one integrated information system is probably necessary to accomplish these ends. Theoretically, the powers necessary for such an agency to coordinate and integrate statistical activities are:[28]

(1) authority to transfer activities from one agency to another;
(2) power to authorize data transfers;
(3) forms control;
(4) guidelines and persuasion of outside task forces;
(5) audit of statistical activities.

To facilitate the exercise of these powers, the agency should compile a checklist of criteria for assessment of budget requests to begin or renew statistical activities that are subject to its approval.

27 President's Commission on Federal Statistics, Report: Federal Statistics (1971).
28 *Id.*

It may also wish to initiate review by an independent board that will consider the collecting, handling and disclosure policies of agencies.

Appendix A
Federal Government Departments and Agencies Involved in the Collection of Data

Statistics Canada[a]

Main Collectors[b]

Agriculture Canada	Canada Employment and Immigration Commission	Department of Energy Mines and Resources
Bank of Canada		

Departments and Independent Regulatory Agencies[c]

Canada Employment and Immigration Commission	Department of Communications	Fisheries and Environment Canada
Canada Post	Consumer and Corporate Affairs Canada	Department of Indian and Northern Affairs and Northern Development
Canadian Radio-Television and Telecommunications Commission	Department of External Affairs	Department of Justice
	Department of Finance	
Air Canada (Transport Canada)	Canadian Dairy Commission (Agriculture Canada)	Cape Breton Development Corporation (Department of Regional Economic Expansion)
Atomic Energy of Canada Limited (Department of Energy, Mines and Resources)	Canadian Grain Commission (Agriculture Canada)	Central Mortgage and Housing Corporation (Ministry of State for Urban Affairs)
Canada Council (Secretary of State Department)	Canadian National Railways (Transport Canada)	Economic Council of Canada (Prime Minister)
Canadian Broadcasting Corporation (Secretary of State Department)	Canadian Transport Commission (Transport Canada)	

a. Collects and provides statistical information on the Canadian Economy and Canadian Institutions. Collaborates with other federal departments and agencies, provincial and municipal governments and with businesses and individuals on the development of methodology on the production of new and expanded statistical information.

b. Each of these departments or agencies is responsible for the collection, analysis and publication of data in specific fields.

c. Both collect large amounts of statistical data as part of their administrative, regulatory and operating responsibilities. Both these groups provide statistical and other data to the Main Collectors, especially Statistics Canada. The difference between the middle and the lower groups is that the middle group comprises basically independent, operational and regulatory agencies. However, the CRTC (a regulatory agency) and UIC (an administrative agency) are incorporated with the lower group of departments and agencies because of their close relationship with the Main Collectors - especially Statistics Canada

partment of Industry, rade and Commerce	Labour Canada Health and Welfare Canada	Public Service Staff Relations Board
nistry of the Solicitor eneral nistry of State for Science and Technology nistry of State for rban Affairs	Department of National Defence Privy Council Office Public Works Canada Department of Regional Economic Expansion Revenue Canada	Secretary of State Department Supply and Services Canada Transport Canada Treasury Board Canada Veterans Affairs Department
tional Energy Board Department of Energy, Mines and Resources) tional Film Board of anada (Secretary of tate Department) tional Harbours Board Transport Canada)	National Research Council of Canada (Ministry of State for Science and Technology) Northern Canada Power Commission (Department of Indian and Northern Affairs and Northern Development)	Northern Transportation Company Limited (Transport Canada) Public Service Commission (Secretary of State Department) Royal Canadian Mounted Police (Ministry of the Solicitor General) St. Lawrence Seaway Authority (Transport Canada)

As of September 1978

Appendix B
Matrix Showing Overlap in Data Collection in the Survey Areas of: Labour, Financial Statements and Capital Expenditures

Survey number	Number and type of reporting units[a]	Labour data				
		Employee count	Salaries and wages	Hours	Employee benefits	Further breakdown[b]
2	1,400 estab.	x	x			
3	250 estab.					
4	13 companies					
5	400 enterprises					
7	100 companies					
8	400 estab.	x	x			x
12	175 companies	x	x			
13	1,000 estab.					
14	75,000 estab.	x				x
16	552 estab.		x			
17	34 estab.		x		x	
19	500 estab.		x		x	
20	120 companies		x		x	
21	940 enterprises		x			
23	1,500 enterprises	x	x			
25	104 estab.	x	x			x
34	8,000 estab.	x				
36	700 estab.	x	x			x
37	708 estab.					
46	1,400 estab.					
47	200 estab.	x	x			
48	100 estab.	x	x			x

a. "Enterprise", "company" and "establishment" are as defined in the *Standard Industrial Classification Manual*, Statistics Canada 1970, cat. no. 12-501.

b. Further breakdown of employee count, salaries and wages, hours and employee benefits.

c. Specific items which are part of profit and loss statement, balance sheet, source and application of funds.

d. Specific items which are part of construction, machinery, and equipment.

e. Further breakdown of construction, machinery, equipment and specific item

ıancial statements					Capital expenditure data				
ofit H ss te- nt	Balance sheet	Source and application of funds	Specific items[c]	Specific financial items	Construction	Machinery	Equipment	Specific items[d]	Further breakdown[e]
			x	x					
				x					
					x	x	x		x
					x	x	x		x
	x								
				x					
	x								
				x					
	x			x					
				x	x		x		
				x					
		x							
				x	x				
				x					
			x						
			x						

Survey number	Number and type of reporting units[a]	Labour data				
		Employee count	Salaries and wages	Hours	Employee benefits	Further breakdown[b]
49	2,800 estab.		x			x
50	112 companies	x	x			
51	2,800 estab.	x	x			x
52	25,000 estab.	x	x			
54	325,000 estab.	x	x	x		
55	25,000 estab.					
56	1,000 estab.	x				
57	150 estab.	x	x			
58	40 companies					
59	4,500 estab.					
60	150 companies					
61	1,900 estab.	x	x		x	
62	519 estab.					
63	39 estab.					
64	19,000 estab.					
65	11,000 companies					
66	550 enterprises					
67	12,000 estab.					
68	30 companies					
69	10,072 estab.					
70	650 companies		x			
71	companies[f]					
72	900 companies					
73	216 estab.					
74	12 estab.					
75	321 companies					
76	5,000 estab.		x			
78	1,450 estab.					
79	4,000 estab.	x	x			
80	20,000 estab.					
81	20,000 estab.					

f. Undefined number.

ancial statements					Capital expenditure data				
fit e- it	Balance sheet	Source and application of funds	Specific items[c]	Specific financial items	Construction	Machinery	Equipment	Specific items[d]	Further breakdown[e]
				x					
			x						
				x					
	x		x						
				x					
			x						
				x					
	x								
				x					
	x								
			x						
			x						
			x						
			x						
			x						
			x						
			x						
			x						
			x						
			x						
			x						
		x	x						
			x						
			x						
			x						
			x						
				x					
				x	x	x	x	x	
				x	x	x	x		x
				x	x	x	x		x

Survey number	Number and type of reporting units[a]	Labour data				
		Employee count	Salaries and wages	Hours	Employee benefits	Further breakdown[b]
82	20,000 estab.					
83	25,000 companies	x	x	x	x	x
84	1,400 companies					
85	9 companies	x	x			
86	271 enterprises	x	x		x	
87	280 enterprises	x	x		x	
88	82 estab.					
89	36 companies	x	x			
92	350 companies	x	x			x
93	549 companies	x	x			x
94	13 estab.	x	x			x
95	10,000 estab.		x			x
96	79 companies	x	x			
97	932 companies	x	x			x
98	10,000 estab.					
99	34 companies	x	x	x		x
100	24 companies	x	x			
104	12,575 estab.	x	x	x		
105	14,000 estab.		x	x	x	
106	51,900 estab.	x	x	x		x
107	6,500 estab.	x				
108	3,000 estab.	x				
109	26,000 estab.	x				
110	430,000 estab.	x				x
111	3,000 enterprises				x	
112	4,000 companies					
113A	250 companies					
113B	5,755 companies					
114	49 companies					
115	256 companies					
116	188 companies					
117	107 companies					
118	111 companies					

ancial statements					Capital expenditure data				
fit l ce- nt	Balance sheet	Source and application of funds	Specific items[c]	Specific financial items	Construction	Machinery	Equipment	Specific items[d]	Further breakdown[e]
				x	x	x	x		
	x			x	x	x	x		
	x			x					
	x	x		x					
	x	x		x					
	x	x		x					
				x					
				x					
	x			x					
	x	x		x					
	x								
	x		x						
	x	x		x					
				x					
	x			x					
				x					
	x								
				x					
	x		x						
			x						
				x					
	x			x					
				x					
			x						
				x					
				x					

Survey number	Number and type of reporting units[a]	Labour data				
		Employee count	Salaries and wages	Hours	Employee benefits	Further breakdown[b]
120	161 companies					
121	166 companies					
122	569 companies					
124	186 enterprises					
125	283 companies					
126	28 companies					
127	1,637 enterprises					
130	12 companies		x			
133	Establishments[f]	x	x	x		x
137	200 companies	x	x	x		
139	131 estab.	x	x			x
140	342 estab.	x	x			x
142	950 companies		x			x
168	1,300 companies		x			x
169	172 enterprises		x			
170	172 enterprises					x
171	60,000 estab.					
172	5,000 estab.	x	x		x	
173	3,000 companies					
174	223,000 estab.					
175	3,000 companies					
177	2,398 estab.	x	x	x	x	x
200	2,000 estab.	x		x		
201	40,000 estab.	x	x	x	x	x
202	30 companies					
204	1,716 enterprises	x	x			
206	36 companies					
207	5 co-ops.					
208	45 companies					
210	14 companies	x	x			
211	321 estab.					
212	410 estab.					
213	1,600 estab.		x		x	

ancial statements					Capital expenditure data				
ofit and ss te- nt	Balance sheet	Source and application of funds	Specific items[c]	Specific financial items	Construction	Machinery	Equipment	Specific items[d]	Further breakdown[e]
				x					
				x					
				x					
			x						
			x						
	x		x						
				x					
			x		x	x	x		
	x			x	x	x	x		
					x	x	x		
	x			x					
			x						
	x			x					
	x			x					
		x		x					
	x	x		x					
	x				x	x	x		
	x			x					
	x	x	x	x					
				x					
	x			x					
	x	x		x					
	x	x		x					
	x			x					
	x			x	x				
	x								
	x	x		x					

Survey number	Number and type of reporting units[a]	Labour data				
		Employee count	Salaries and wages	Hours	Employee benefits	Further breakdown[b]
216	Companies[f]	x				x
219	50 enterprises					
221	180 companies					
222	375,000 estab.					
223	260,000 estab.					
224	112,000 estab.					
225	18,000 companies					
226	Companies[f]					
227	4,800 companies					
229	10,000 companies					
230	200 companies					
231	536,000 estab.	x				
232	40,000 estab.					
233	200 estab.					
234	3,800 companies					
235	14,785 companies					
237	12,000 companies					
238	65,000 estab.					
239	65,000 companies					
241	329 estab.					
242	550 estab.					
243	800 estab.					
245	75 companies					
247	457,511 estab.	x				x
249	60,000 estab.	x				x
259	162 companies	x				
260	600 estab.	x	x			x
261	600 government and companies	x				x
268	200 companies					
269	575 companies and establishments					
270A	328 companies					

ıancial statements					Capital expenditure data				
ɔfit ıd ss te- ınt	Balance sheet	Source and application of funds	Specific items[c]	Specific financial items	Construction	Machinery	Equipment	Specific items[d]	Further breakdown[e]
				x					
	x	x		x					
	x	x		x					
				x					
			x						
			x						
	x			x					
	x			x					
	x			x					
	x			x					
	x			x					
				x					
				x					
				x					
				x					
				x					
			x						
			x	x					
			x						
			x						
			x						
					x				
			x						
				x	x	x	x		x
				x					

Survey number	Number and type of reporting units[a]	Labour data				
		Employee count	Salaries and wages	Hours	Employee benefits	Further breakdown[b]
270B	328 companies					
275	42 industries and estab.					
278	1,000 companies					x
280	41,000 estab.	x	x	x	x	x
400	750 estab.	x	x		x	
401	150 estab.	x	x		x	
500	9 estab.					
501	104 estab.					
502	19 companies					
503	16 enterprises					
504	9 companies					
505	9 companies					
506	9 companies					
507	9 companies					
508	9 companies					
509	9 companies					
510	9 companies					
511	33 companies					
512	17 companies					
513	12 companies					
600	11 companies					
601	10 companies					
602	11 companies					
603	10 companies					
604	10 companies					
605	10 companies					
606	10 companies					
607	10 companies					
700	6,500 estab.					
702	12,000 estab.					
703	Companies[f]					
704	5,974 estab.					

inancial statements					Capital expenditure data				
rofit nd ss ate- ent	Balance sheet	Source and application of funds	Specific items[c]	Specific financial items	Construction	Machinery	Equipment	Specific items[d]	Further breakdown[e]
				x					
	x	x		x					
	x	x		x					
		x							
				x					
	x			x					
				x					
	x								
				x					
				x					
				x					
	x			x					
				x					
	x			x					
	x			x					
				x					
	x			x					
	x								
	x			x					
	x								
	x								
		x							
		x							
		x							
	x								
	x			x					
	x			x					
	x			x					
	x			x					

Survey number	Number and type of reporting units[a]	Labour data				
		Employee count	Salaries and wages	Hours	Employee benefits	Further breakdown[b]
706	5,974 estab.					
708	40 estab.					x
709	400 companies					x
710	165 estab.					
711	23,000 estab.					
712	23,000 estab.					
	Total of 188 surv.	54	56	12	16	33

nancial statements					Capital expenditure data				
rofit ad ss ate- ent	Balance sheet	Source and application of funds	Specific items[c]	Specific financial items	Construction	Machinery	Equipment	Specific items[d]	Further breakdown[e]
	x			x					
				x					
	x			x					
				x					
	62	20	40	98	16	12	13	1	5

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Securities Regulation: Problems in Relation to Sanctions

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Chapter I
Introduction

This paper will, I fear, appear to be somewhat diverse in content. It is not a treatise, nor is it an article for a learned journal, but rather a working paper which is designed to raise policy issues for resolution prior to the preparation of legislation. It goes however beyond simple proposals for legislation as such, and discusses wider matters of contemporary interest and importance pertaining to the field generally. Thus, I have dealt with problems of sanctioning in their widest connotation, including both criminal sanctions and civil liability and aspects of matters allied to criminal and civil proceedings. It deals with investigations, and what might be considered as criminal intelligence or more broadly perhaps, the amassing of information about persons engaged in the securities business. Such matters as the possible oversight by a government body of self-regulatory agencies are also mentioned because they affect the way in which such agencies carry out their duties and the standard which they attain. This paper does not deal with self-regulatory agencies as such. That is the concern of other working papers. It does deal with cooperation between

I owe a debt to many of the other participants in the study and in particular to P. Anisman, former Director of Corporate Research, Consumer and Corporate Affairs Canada, and to Professor Warren Grover of Osgoode Hall Law School, York University.

various regulatory agencies and with other agencies generally involved in the field of criminal law and industry regulation.

Inevitably the paper lays stress on the U.S. Securities and Exchange Commission (SEC) practices. It also mentions in part the practices of the Ontario Securities Commission and other provincial commissions. The stress on matters American is attributable simply to the fact that the SEC is the largest and most sophisticated agency at work in this particular field.

No attempt has been made to cite all the available materials. My interest has been not in an exhaustive examination of all the possible case law and statute law available with a view to writing a treatise on the activities of one or more agencies, but rather to present a broad view of the types of sanctions and enforcement procedures used by regulatory agencies. My aim has been to ascertain what ideas and procedures we might find useful in Canada with or without any modification. Where, however, legal difficulties appear in Canada in relation to any part of the material, I have endeavoured to set out the relevant case and statute law in order to facilitate assessment of any recommendations contained herein.

Chapter II
Enforcement

A. THE EXISTING CRIMINAL CODE PROVISIONS (OUTLINE)

Certain types of offences related to securities are prohibited under Canada's Criminal Code. The provisions of the code and in particular the sections relating to false pretences, fraud and manipulation have been directed towards the grosser forms of fraudulent conduct. In addition, since the creation of regulatory commissions operating under statute, there have been a number of offences, contained in provincial securities legislation, directed toward the control of the securities industry in general. These go beyond fraud, ensuring that disclosure is made, that participants in the industry are adequately capitalized, that principals and salesmen observe standards of ethical conduct and that broker-dealers and other persons employing representatives supervise the activities of such persons. Breach of this latter group of standards may, typically, give rise to criminal prosecution, to intervention by civil process and to administrative sanctions. They contain matters of fundamental importance. Indeed, although in many cases breach of the rules laid down in the provincial acts cannot

firmly be attributed to fraud, the nonobservance of such rules is very often a first step in a fraudulent scheme. It is perhaps worth repeating the obvious point that persons can be damnified by overenthusiastic, albeit honestly made, representations as well as by schemes of fraud as such.

There appear to be at least three sets of problems relating to provisions prohibiting fraudulent conduct in the securities field. These are:

(1) Does the Criminal Code deal adequately with fraud?

While I do not deal with this question in this paper in detail, it seems appropriate to note that the ambit of the Criminal Code provisions on obtaining by fraud is extremely wide.[1] The relevant sections of the Criminal Code are:

False pretences. Section 320. This provision comprehends obtaining anything in respect of which theft may be committed or causing it to be delivered to another person, or obtaining credit by a false pretence or by fraud (a wider concept) or making a false statement in writing relating to the financial condition of himself or any person, firm or corporation with intent that it should be relied upon for the purpose of procuring, *inter alia*, the payment of money, the making of a loan, or the delivery of personal property.

Fraud affecting a public market. Section 338. This provision derived from the common law offence of conspiracy to cheat and defraud, penalizes (in subsection (1)) defrauding the public or an individual by any fraud, whether or not it is a false pretence, of any money, property, or valuable security. Subsection (2) is sufficiently important to warrant citation in full:

"(2) Every one who, by deceit, falsehood or other fraudulent means, whether or not it is a false pretence within the meaning of this Act, with intent to defraud, affects the public market price of stocks, shares, merchandise or anything that is offered for sale to the public, is guilty of an indictable offence and is liable to imprisonment for ten years."

Using the mails to defraud. Section 339. This penalizes use of the mails for the purpose of transmitting letters or circulars concerning schemes devised or intended to defraud the public or for the purpose of obtaining money under false pretences.

Fraudulent manipulation of stock exchange transactions. Section 340. This provision, derived from section 9(a) of the U.S.

1 For a detailed discussion *see* J. Williamson, Supp., ch. 6.

Securities Exchange Act of 1934, was introduced into the Criminal Code in 1948.[2] It provides:

"Every one who, through the facility of a stock exchange, curb market or other market, with intent to create a false or misleading appearance of active public trading in a security or with intent to create a false or misleading appearance with respect to the market price of a security:

"(a) effects a transaction in the security that involves no change in the beneficial ownership thereof;

"(b) enters an order for the purchase of the security knowing that an order of substantially the same size at substantially the same time and at substantially the same price for the sale of the security has been or will be entered by or for the same or different persons, or

"(c) enters an order for the sale of the security, knowing that an order of substantially the same size at substantially the same time and at substantially the same price for the purchase of the security has been or will be entered by or for the same or different persons,

is guilty of an indictable offence and is liable to imprisonment for five years."

Gaming in stocks or merchandise. Section 341. This section penalizes gaming. It is intended to halt bucket shops in which the essence of the transaction is a bet upon whether commodities will rise or fall, under the guise of fictitious sales and purchases.[3]

Broker reducing stock by selling on his own account. Section 342. The essential thrust of this offence is to protect purchasers of shares on margin. It penalizes brokers who deal in shares on the margin for a customer and who, also dealing in such shares on their own account, reduce the amount of such shares in the hands of the broker or under his control in the ordinary course of business below the amount which the broker should be carrying for all customers.

False prospectus. Section 358. This section in fact goes beyond a prospectus as that term is commonly understood. It provides:

"(1) Every one who makes, circulates or publishes a prospectus, statement or account, whether written or oral, that he knows is false in a material particular, with intent:

2 *See* MARTIN'S CRIMINAL CODE, 1955 554 (J. Martin ed.).

3 Pearson v. Carpenter & Son, 35 S.C.R. 380 (1904); Beamish v. Richardson, 23 C.C.C. 394 (S.C.C. 1914); and *see* MARTIN'S CRIMINAL CODE, *supra* note 2, at 556-57.

"(a) to induce persons, whether ascertained or not, to become shareholders or partners in a company;
"(b) to deceive or defraud the members, shareholders or creditors, whether ascertained or not, of a company;
"(c) to induce any person to entrust or advance anything to a company, or
"(d) to enter into a security for the benefit of a company, is guilty of an indictable offence and is liable to imprisonment for ten years.
"(2) In this section, 'company' means a syndicate, body corporate or company, whether existing or proposed to be created."

Provincial legislation does not in general contain broad anti-fraud provisions. It is interesting that under the British Columbia statute a prohibition against insider trading is made a criminal offence.[4] Ontario Bill 20 also makes provision for this offence. It is proposed that contravention should be a summary conviction offence punishable in the case of a company with a fine of not more than $25,000 or in the case of an individual with a fine of $2,000 or to imprisonment for a term of not more than one year, or both.[5]

While this paper does not purport to deal with the substantive criminal law in detail, the difficulties to which the existing provisions have given rise render a few comments necessary on the following discussion of procedures and sanctions. The first and most obvious point is that the coverage achieved in the Criminal Code is wide. Virtually the only gap in the coverage provided by the Code relates to the obtaining of credit by fraudulent future forecasts which falls outside both the fraud and false pretence sections. This should certainly be put right and could be done by a minor legislative amendment to the definition of false pretence in order to make that definition cover representations concerning future conduct. In most securities cases, however, money or valuable security is obtained and therefore the fraud section readily applies.

The general fraud section, section 338, is a broad, functional provision which is not restricted to the technical definitions either of false pretence or of wash trading or other particularized forms of manipulation.[6] It applies both to stock and commodity markets. Mere nondisclosure of a material fact is not sufficient to convict. To deceive is defined as inducing someone to believe that a thing is true which is false and which the person practising the falsehood

4 British Columbia Securities Act, s. 111.
5 Ontario Bill 20, cls. 77, 121(1)(c).
6 R. v. Marquardt, 6 C.C.C. (2d) 372 (B.C.C.A. 1972); R. v. Knelson and Baran, 133 C.C.C. 210 (B.C.C.A. 1972).

knows to be false.[7] The test of manipulating a public market is said to be whether the activities were conducted not to stabilize the price of the securities involved, but rather to drive them up to a level disproportionate to their intrinsic value.[8] This test is of course impressionistic; it renders the provision one which can safely be employed only in very clear cases. The section has been employed in at least one insider trading case, *R. v. Littler*[9] where the accused obtained shares in a company from other shareholders by denying the truth of rumours of a lucrative takeover offer of which he later took advantage. Similarly, the false prospectus provisions have been given a broad and liberal construction.[10]

The most troublesome provision has been the anti-manipulation provision, section 340. It is not clear why prosecutions have been brought under this provision. As the essence of manipulation is fraud,[11] the general fraud section could, seemingly, be relied upon in any case. However, prosecutions brought under section 340 have enountered difficulties in proving intent to manipulate even where the existence of substantially matching orders could be shown. The difficulty is that stabilizing transactions for the purpose of effecting a block acquisition are lawful since matched orders are not unlawful *per se*.[12] There is also a potential problem in demonstrating matching. The difficulties posed by the section led a federal-provincial technical working group in 1966 to recommend redrafting section 340 and to suggest the enactment of a new section relating to the manipulation of an independent market.[13] There seems little doubt that, at least for a time, a lack of success in prosecutions brought under section 340 led to its nonuse.

(2) Have adequate sanctions been provided?

(3) Is the law being adequately enforced?

This can be taken to refer not only to whether proceedings are

7 R. v. Thornson, 39 C.R.N.S. 7 (Man. C.A. 1977); R. v. Brasso Datsun Ltd., 39 C.R.N.S. 1 (Alta. S.C. 1977).

8 McNaughton v. The Queen, 33 C.R.N.S. 279 (Qué. C.A. 1976); *see also* Klein, *Stabilizing Securities Prices*, 5 Sec. Reg. L.J. 13 (1976).

9 65 D.L.R. (3d) 443, 467 (Qué. C.A. 1974); and *see* Johnston, Note, 2 Can. Bus. L.J. 234 (1977).

10 Cox and Paton v. The Queen, [1963] 2 C.C.C. 148 (S.C.C.); R. v. Colucci, [1965] 4 C.C.C. 56 (Ont. C.A.); R. v. Scallen, 15 C.C.C. (2d) 441 (B.C.C.A. 1974).

11 Loomis, *Enforcement Problems Under the Federal Securities Laws*, in American Bar Association, Selected Articles on Federal Securities Law 177, 190 (H. Wander & W. Grienenberger eds. 1968).

12 I am indebted for some part of this discussion to J. Howard, Capital Market Criminal Code (unpublished paper prepared for Canadian Bar Association Panel, August 23, 1974). *See* in particular R. v. Jay, [1965] 2 O.R. 471 (C.A.); R. v. Lampard, 4 D.L.R. (3d) 98 (S.C.C. 1969).

13 *See* J. Howard, *supra* note 12.

being initiated, but also to whether the courts are adequately punishing those offenders who are convicted.

In assessing the adequacy of enforcement procedures in this area, it must be borne in mind that the question which we face is wider than whether the legislation is being enforced in such a way as to minimize fraud in the purchase and sale of securities. There are further and other questions which confront us. Principal among these is the need for public confidence in the system of criminal justice. Public confidence in the administration of criminal justice should not be challenged by blatantly favourable practices conducted by white collar offenders. It may be the case, for example, that administrative sanctions will, in almost every instance, adequately deter persons from engaging in fraudulent or manipulative activities. Even if this were the case and it seems obvious enough that it is not, many persons might properly resent the fact that criminal proceedings were not taken against such persons while petty thieves were charged and convicted in a routine fashion in the criminal courts.

There are, however, general considerations which militate against simple reactions to the problem of enforcement. For example, the criminal law is a blunt instrument. It is a useful method where egregious cases of fraud are concerned provided that technical problems of the presentation and proof of cases can be overcome. To do so is often difficult; the line between impermissible manipulation and permissible stabilization can become so thin as virtually to be indistinct. In cases where fine discriminations must be made between permissible and impermissible conduct, proscriptions based upon fraud and the proof of fraud are often misplaced. Adherence to criminal provisions of this sort enforced either through the courts or administrative bodies results in inefficacious enforcement procedures or, as in the United States, the erosion of traditional *mens rea* concepts in order to maintain the integrity of the enforcement procedures.

The latter development has been very marked in securities regulation.[14] In effect, we need not only criminal sanctions directed towards clear frauds in securities regulation as in other regulatory areas, for example income tax, but also provisions and sanctions which relate to a host of reporting and similar requirements where we cannot afford the luxury of abstaining from enforcement until fraud can be shown. We need strict provisions enforced either through the lower criminal courts or administrative bodies. Where the legality of conduct involves fine discrimina-

14 James, *Culpability Predicates for Federal Securities Law Sanctions: The Present Law and the Proposed Federal Securities Code*, 12 HARV. J. LEGIS. 1, 1–62 (1974).

tions, intelligible technically to specialists and appropriate to the regulation of activities engaged in the industry, administrative controls are imperative.[15] Furthermore, in evaluating enforcement schemes we must look both at the totality of the problem and the totality of the response. It would, for example, be wrong to overlook the regulatory impact of noncriminal procedures, or *a priori* to ascribe their use simply to class favouritism. Crude attitudinizing is not helpful.

Subject to the above comments, crimes in relation to securities where the conduct involved is fundamentally fraudulent, ought, in my submission, to be dealt with in exactly the same way as any other crime of dishonesty. The normal decision in a clear fraud case would be to proceed by criminal prosecution. There are of course valid reasons for determining not to prosecute in particular cases. These are, in general, personal to the offender. Among them might be the stale character of offences, grave illness or senility on the part of the offender, the isolated nature of the occurrence and so on. In addition the sheer complexity of securities cases may require an agency to be somewhat selective in its prosecution policies.

The difficulties encountered in the enforcement of securities legislation are dealt with by Ogren.[16] He points out that in stock manipulation such activities are usually engaged in by a well-financed, sophisticated group of individuals including brokers, bankers and promoters who carefully arrange and conduct widespread purchases and sales of stock through nominees. In such a case the SEC will usually order an investigation only when the price of stock has collapsed and the investor has taken a loss. The SEC must then analyze buy/sell orders, it must trace bank accounts and financing arrangements. It is not unusual for a criminal reference by the SEC to the United States attorney's office to take place several years after the offence, when the witnesses have dispersed and the evidence is stale. Such cases can go on in the United States for several years after proceedings are instituted. Similar difficulties have been encountered in Canada under the anti-manipulation section of the Criminal Code.

We recognize that generally there can be no arbitrary divorce between enforcement policy and substantive law. The two clearly interact. Few enforcement authorities are prepared to waste time

15 *See e.g.* L. Loss, Proposals for Australian Companies and Securities Legislation: Comments from the American Experience (July 13, 1973) (Report tabled by Attorney-General of Australia in Senate, September 12, 1973), CCH Aust. Sec. L. Rep., Special Report, September 20, 1973.

16 Ogren, *The Ineffectiveness of the Criminal Sanction on Fraud and Corruption Cases: Losing the Battle Against White-Collar Crime*, 11 Am. Crim. L. Rev. 959 (1973).

and money prosecuting persons under provisions which are practically unenforceable. Other factors which militate against a decision to prosecute are high costs, undermanned enforcement agencies, and perhaps deliberate policies of attempting to enlist the support of industry.[17] Of course some of these difficulties do not exist in Canada to the same extent that they exist in the United States. The difficulties encountered in the United States may have prevented the SEC from pursuing vigorously a policy of prosecuting in cases of fraud. The SEC annual reports however note a number of fraud prosecutions undertaken each year with, as far as we can determine, satisfactory results. Philip Loomis argues that the most significant shift in enforcement emphasis since 1959 has resulted from the increased willingness of United States' attorneys, particularly in New York and other large metropolitan areas, to undertake the complex task of investigating and prosecuting large complicated securities fraud cases. Providing necessary cooperation in this area has become a major part of the commission's enforcement effort.[18] However, it has been said by a former member of the commission that there is a failure to use the criminal provisions sufficiently in fraud cases and that this is one of the real shortcomings of securities law enforcement.[19] Problems of complexity must not be allowed to dominate the prosecution function.

There has been controversy over the best method of deterring so-called "economic" or "white-collar" crimes. The terms signify a rough description of the offence or the offender. They do not define constituent elements peculiar to any particular type of offence. Andenaes uses the term "economic crime" to denote crimes against governmental regulation of the economy and states that:[20]

> "Psychologically we can also put customs and tax evasion in this group, although logically these crimes belong in the fraud category."

Any temptation to do so in the realm of securities fraud should be resisted. That such temptations exist seems clear. The fraud employed in manipulating a market may lack the immediacy of

17 Seymour, *Social and Ethical Considerations in Assessing White Collar Crime*, 11 Am. Crim. L. Rev. 821 (1973) notes that the SEC has so few personnel that it can only audit the books of each mutual fund in New York once every 17 years.

18 J. Howard, *supra* note 12. SEC enforcement policy is also outlined in Matthews, *Criminal Prosecutions Under the Federal Securities Laws and Related Statutes: The Nature and Development of SEC Criminal Cases*, 39 Geo. Wash. L. Rev. 901 (1971).

19 *See, Securities Enforcement: A Growth Industry - Cops Patrolling The White Collar Beat*, 397 BNA Sec. Reg. & L. Rep., June 6, 1977, at AA-1.

20 Andenaes, *General Prevention - Illusion or Reality*, 43 J. Crim. L. Criminology & Police Science 179 (1952).

impact of, for example, the traditional false pretence in which a shopkeeper hands over goods in return for a worthless cheque. Because the mechanics of the offence may be little understood and its effects while widespread are not something with which the general public identifies, there may be a tendency to employ administrative measures. The use of noncriminal sanctions in relation to economic crimes is common in the United States and there is a considerable literature on the subject. We do not feel that the fraud offences should be denatured by the exclusive use of administrative sanctions. Serious fraud should be punished criminally. The considerations commonly advanced favouring administrative sanctions for economic offences really do not apply here. The conduct proscribed has traditionally been considered to be criminal. Laws against fraud are not novelties in business circles. The offences are clearly not minor.[21] Furthermore, we must now reckon with an organized crime element in the Canadian securities market. A British Columbia report concluded:[22]

> "The law enforcement agencies have estimated that approximately 20 to 30% of the mines and local junior industrial stocks listed on the Vancouver Stock Exchange are manipulated."

It is right to record that the Vancouver Stock Exchange has disputed the extent of manipulation, but not that there is manipulation in fact.[23] RCMP officers have concluded that stock frauds are an area into which organized criminals enter.[24] None of this need occasion surprise; the SEC has for some years been concerned by the problem, and the intervention of organized crime into such conceptually related areas as tax frauds has become a matter of note in Europe in recent years.[25]

We have already drawn attention to some of the obvious dangers. One tendency is to stay prosecution in the hope of enlisting the support of the industry. In this respect U.S. experience is not encouraging. The Sherman Act (on antitrust) is, for example, criminal in form. In a series of pioneering studies the late Professor Sutherland found a pattern of recidivistic infractions of the Act by

21 For general discussions of this issue, *see* Kadish, *Some Observations on the Use of Criminal Sanctions in Enforcing Economic Regulations*, 30 U. Chi. L. Rev. 423 (1963); Ball & Friedman, *The Use of Criminal Sanctions in the Enforcement of Economic Legislation: A Sociological View*, 17 Stan. L. Rev. 197 (1965).

22 Co-ordinated Law Enforcement Unit, Initial Report on Organized Crime in British Columbia (Dept. of the Attorney-General, 1974).

23 The Globe and Mail (Toronto), October 29, 1974, at B16, col. 1.

24 *Canada's Top Criminals Move into Big Time Fraud*, The Globe and Mail (Toronto), April 2, 1975.

25 *See* J. Mack, The Crime Industry (1975); J. Cosson, Les industriels de la fraude fiscale (rev. ed. 1974).

some seventy large corporations. He attributed such infractions in part to the use of noncriminal sanctions, which enabled the business institutions concerned to escape the stigma of criminality. As Sutherland states when speaking of crimes dealt with in Federal statutes pertaining to anti-trust and similar regulatory legislation:[26]

> "The violations of these laws are crimes...but they are treated as though they were not crimes, with the effect and probably the intention of eliminating the stigma of crimes."

Furthermore, no consistent policy was adopted with respect to the manner of proceeding against violators. Enforcement policy on antitrust has of course been inhibited by other factors, notably the notoriously vague content of the Sherman Act. In only a minority of cases, where clarity had been achieved by judicial decision, was the apt remedy thought to be in prosecution.[27] While Sutherland's study has been criticized as too loosely drawn for analytical purposes, it has considerable value, not least in noting the ambivalence with which offenders were regarded both by the courts and the public. It further stresses the problems which arise when enforcement policy is inconsistent.

Some of the enforcement problems which can arise are stressed by M. Clinard's study of the wartime black market operating in the United States. Many violations were felt by the Office of Price Administration (OPA) to be wilful, but in only a minority of cases was evidence found that was sufficient to lead to a criminal conviction. Most cases were not disposed of by prosecution. Only 6% of some 289,966 cases of violations were prosecuted. By the end of the war the OPA policy of cooperation with businessmen was found to be in ruins. Administrative measures did not suffice. While imprisonment was the sanction most feared by businessmen, it was seldom employed. Enforcement became ineffective.[28]

A further study by R. Lane throws light upon another aspect of the problem.[29] It has been asserted before the Ontario Securities Commission that violators were unaware of commission policies, though the policies in question had been promulgated in the commission's Bulletin.[30] Lane's findings cast some doubt upon the validity of such excuses. He concludes that most violations of regulatory offences are either wilful or the result of inadvertent

26 *See, Is "White Collar Crime" Crime?*, 10 Am. Soc. Rev. 132, 136 (1945).
27 *See* Kramer, *Criminal Prosecution for Violation of the Sherman Act*, 48 Geo. L.J. 530 (1960).
28 *See* M. Clinard, The Black Market (1952).
29 *See* R. Lane, The Regulation of Businessmen (1954).
30 [1961] OSC Bull. 1 (March).

misapplication of legal provisions. Violations resulting from ignorance of legal provision were less common. These findings have a bearing on policy, particularly where offences are on (if not over) the borderline of fraud. In the area of securities regulation we are dealing with a fairly closely knit community to the members of which commission policy must be familiar.

These considerations were also considered by judges of the U.S. Federal Courts in a Pilot Institute on Sentencing.[31] Among the topics discussed was sentencing of the income tax violator. Some of the matters referred to are clearly pertinent here. The first factor to which attention was drawn was a remarkable disparity of sentences. This is said to result from judges according different weight to some characteristics of the offenders, notably their previous good reputations in business and civic activities, though a recent study suggests that such variations were found in sentencing for a wide range of crimes.[32] The weight to be given to such considerations is disputed. We would agree with Judge Boldt who states:

> "The gifted and fortunate person has a high stake in our society and a special responsibility for setting standards of conduct and for providing an example of obedience to and compliance with the tax statutes as well as all other civil and criminal laws. The few of such individuals who deliberately breach their duty hardly are deserving of more lenient treatment than those not so talented and less favoured in education, position and wealth.[32a]

We would further agree with Judge Boldt and Judge McIlvaine that initially the primary purpose of sentencing in tax matters must be deterrence. We consider that this is also true in the area of securities fraud. We recognize that in securities fraud, the professional swindler is likely to be involved. The judges distinguished between situational offenders who, for example, succumb to temptation and embezzle and the aggressive person who considers himself to be a sharp promoter rather than a criminal. We do not think that this latter type of offender should be afforded the luxury of such a rationalization. Furthermore, the U.S. federal judges regard this latter type of offender as a poor rehabilitation

31 *See* 26 F.R.D. 264 (1960).

32 A. Partridge & W. Eldridge, The Second Circuit Sentencing Study (Federal Judicial Centre 1974).

32a 26 F.R.D. at 268.

risk.[33] The view was also expressed that lenient treatment for "white-collar" offenders may lead to public disrespect for the law.

There is another pertinent analogy from the tax field. Judge Boldt points out that the system is really one of self-enforcement based on expected integrity in compliance from the majority of tax payers and states:

> "That system could easily and quickly collapse if its basic assumptions failed and fraud by individuals in their self-assessment of tax liability occurred in any substantial frequency.[33a]

The same considerations pertain to the securities field. An attempt has been made to cause the industry to police itself within a broad framework of control.[34] Unless the available sanctions are used in cases clearly warranting their application, self-regulation could break down. If offenders were subject to adequate sanctions, the industry might well feel it to its advantage to subsidize more heavily its institutional means of control. And the institutions concerned would have a greater ability and incentive to police the activities of persons therein engaged more rigorously. This in turn could alleviate the burdens facing regulatory agencies, enabling them to reserve their energies for the more serious forms of conduct. It should also lead to a more consistent and thorough policing policy. The impact of the criminal law and of administrative enforcement should become more comprehensive and better understood, both generally and in the eyes of the industry. At present, for example, the criminal law appears (at any rate to the outsider) capricious in its incidence. Indeed, in the U.S. the SEC has been criticized for reliance upon consent decrees. It is alleged that while this may be effective in sparing the SEC inconvenience and expense, it engenders the belief among investors and others that villains go unpunished and the market is insufficiently policed.[35]

A policy of substantial reliance on administrative measures in

33 Though this view is certainly not unanimously held; *See* the remarks of Judge Carter in 26 F.R.D. at 356 and in particular his scepticism about deterrence. Again, we would emphasize that in securities fraud the impact of conviction will be felt by a relatively small segment of the community. Interestingly perhaps, the U.K. Parole Board takes a similar view of the unsuitability of parole to offenders whose livelihood is fraud. I am indebted to the late Lord Justice James and to Sir Louis Petch for information.

33a 26 F.R.D. at 268.

34 For discussion of the U.S. experience *see* Knauss, *A Reappraisal of the Role of Disclosure*, 62 Mich. L. Rev. 589 (1964); Cary, *The Special Study of Securities Markets of the Securities and Exchange Commission*, 62 Mich. L. Rev. 557, 566 (1964).

35 Sargent, *The SEC and the Individual Investor. Restoring His Confidence in the Market*, 60 Va. L. Rev. 553 (1974); Editorial, *Aiming at Wrong Target*, The Commercial and Financial Chronicle, July 8, 1974, at 6, col. 1.

cases where egregious conduct falls squarely within the Criminal Code may lead to undesirable social consequences. The primary aim of the criminal law in the field of securities offences must be deterrence. Deterrence must be directed towards those active in the field. It does not depend entirely upon a Benthamite criminal weighing the formal penalty likely to be inflicted against the amount of money which he can be expected to gain. As Andenaes has pointed out, modern penal theory postulates deterrence as a general aspect of a system of social control. He states:

> "The idea is that punishment as a concrete expression of society's disapproval of an act helps to form and strengthen the public's moral code and thereby creates conscious and unconscious inhibitions against committing crime."[36]

Thus deterrence is not only a function of fear. It does, however, suggest that legal prohibitions have a long-term effect in strengthening and perhaps creating general moral inhibitions as well. For our purposes both aspects are of importance. Punishment, Andenaes states, may have a deterrent effect, a moralizing effect and may stimulate habitual law-abiding conduct. Of these functions, the latter two are of long-term importance.

If one adopts Andenaes' theory the possibility of undesirable consequences from overemphasis on purely administrative sanctions becomes evident. No small part of punishment lies in the stigma and publicity given to the offence. It is interesting that Canadian and American securities commissions make extensive use of publicity for sanctions of all sorts. Both as an information device and an aid to deterrence, the use of publicity would seem to be a commendable development. The offender loses status to the extent that society reprobates or can be made to reprobate the crime. One would expect this loss of status to reflect later in general inhibitions against such conduct. If securities offenders appear to receive preferential treatment, this valuable long-term effect may be substantially lost.[37] An ineffective system and a want of values and controls may lead to an exaggerated reaction in which exemplary sentences may be imposed in an attempt to recover lost ground. Furthermore, undue leniency could cause a public lack of confidence in enforcement agencies. Both the public and those active in the industry may derive the impression that

36 *See* Andenaes, *supra* note 20.

37 *See e.g.* Bosly, *Les frontières de la répression pénale en droit économique*, [1972-73] REVUE DE DROIT PÉNAL ET DE CRIMINOLOGIE 137; Matthews & Sullivan, *Criminal Liability for Violations of the Federal Securities Laws: The National Commission's Proposed Federal Criminal Code, S. 1 and S. 1400*, 11 AM. CRIM. L. REV. 883 (1973) argue for a clarification of prospectus fraud and false filing offences as felonies in order to emphasize the seriousness of such conduct.

fraudulent and manipulative practices are not strongly reprobated.[38] An unhealthy ambivalence in attitudes could result. Furthermore, as we have noticed, unhealthy stresses in the community could become evidence if other categories of offenders appeared to receive condign sentences.

Interestingly enough the tendency to overcompensate is found in some sociological writings. Thus Ogren in his article complains that whilst extensive fraud cases are in progress accused persons are likely to be free on bail during the entire process.[39] Such persons he suggests carry on business as usual for a number of profitable years. This may of course be so. But, it is surely not desirable that accused persons in complicated cases be held in custody during the entire period of investigation and trial. It would be intolerable in our system to have cases like *Matznetter* and *Stogmuller* where the accused persons spent years in an Austrian prison awaiting the bringing of their case to trial and the end of the pretrial investigations. These cases have justly been considered a blot on the record of the country concerned.[40] It is obviously desirable that securities fraud cases be treated as fraud cases. It is not desirable to overreact, subjecting securities or suspected securities offenders to treatment of an exemplary character. We must treat crimes as crimes. We must not allow honest indignation to distort the whole of the criminal justice system.

Similar concerns have been voiced about sentences imposed upon white-collar offenders in relation to fraud offences. Thus, for example, Seymour in a general survey of the topic contends that there is an unwelcome disparity in the sentencing of common criminals and white-collar criminals.[41] He refers to a sentencing study conducted in 1972 in the southern district of New York. That study indeed revealed that white-collar offenders, primarily white, received more lenient treatment than persons charged with common crimes, a group of offences largely committed by unemployed and undereducated persons. The latter (deprived) group is more likely to be sent to prison. In relation to securities matters prison was invariably awarded for the theft of securities, but for securities fraud offences 66% of convicted offenders went to prison and for a lesser term than the average common criminal. There were lighter sentences still for tax evasion.

Seymour from these findings argues that there is a need for a more evenhanded approach to sentencing; that the basic sen-

38 This concern is particularly stressed in Sargent, *supra* note 35.

39 Ogren, *supra* note 16.

40 12 Y.B. European Convention on Human Rights 364, 406 (1969); *see also* the case of Neumeister, 11 Y.B. European Convention on Human Rights 826 (1968).

41 *See, supra* note 17.

tencing structure employed by the United States' courts is unfair. Among his recommendations are: the collection of data on sentencing for circulation to the judges, annual sentencing institutes within the various circuits, annual conferences on sentences with a goal of seeking common policy and an emphasis on deterrence in white-collar crimes. He thus recommends fixed sentences to be served in institutions where the primary aim is custodial rather than rehabilitative. No parole should be allowed.

The general concern that underlies this sort of discussion may be applauded. No doubt some of the practical matters stressed in writings on white-collar crime can usefully be employed in enforcement. The deterrent value of prison terms in relation to white-collar offenders is now well documented. There is no reason why someone of an upper socio-economic level should be better treated than someone from the ghetto. There are, however, aspects of these arguments that bother me.

In the first place it is by no means clear that in the United States at any rate, sentences imposed upon securities offenders are unduly lenient. It is true that there are cases noted in the SEC annual reports at which one expresses surprise that a prison term was not awarded. Lenient sentences are also sometimes awarded in Canada. On the other hand, both in the United States and in Canada there are abundant examples of substantial prison terms being imposed for fraudulent and manipulative conduct. Recently, for example, we have seen forthright statements in Canadian and United States courts that white-collar offenders are not to be placed in a privileged position. In *R. v. Ocean Construction Supplies Ltd.*[42] a case of conspiracy to violate the Combines Investigation Act, the court held that fines in such cases ought to be high enough to convey a sense of shock. Prison sentences for manipulation have been handed down.[43] In a Québec decision, *R. v. Littler*,[44] prison terms of two years were imposed in a case of fraud contrary to section 338(1) of the Criminal Code where the accused, by misrepresenting his intentions and not disclosing to his vendor a more favourable offer for the vendor's shares was able to purchase at a low price and sell at a substantial profit.

In the United States there have been several examples of prison sentences imposed in cases of securities fraud.[45] When

42 18 C.P.R. (2d) 166 (B.C.C.A. 1974).

43 *E.g.* Nantel v. The Queen, 26 C.R.N.S. 359 (Que. C.A. 1973); R. v. Kirsh (Ont. H.C. 1977) (unreported decision of Haines, J.); and *see, Lawyer Sent to Jail for Fraud Conspiracy*, The Globe and Mail (Toronto), November 13, 1976.

44 65 D.L.R. (3d) 443, 467 (Qué. C.A. 1974).

45 *E.g.* the prison sentences handed down in the wake of the Equity Funding Affair; *see* The Wall Street Journal, April 15, 1975, at 22, col. 3 (Fred Levin); The Wall Street Journal, March 26, 1975, at 13, col. 1 (noting prison terms of up to eight years for the

counsel had the temerity to argue for a lenient sentence for his client, basing the argument upon a survey which showed that white-collar offenders generally obtained better treatment than ordinary thieves and burglars, the court, expressing the view that such a situation was scandalous, imposed a twenty-five year sentence for crimes of pledging stolen securities.[46] There are, it seems, occasions in which recourse to the "Brandeis brief" is at least unwise.

No doubt the courts sometimes err on the side of leniency in the area of securities fraud: but there does not appear to be any reason to think that the courts consistently treat offenders too leniently. There is, however, a body of informed opinion to the contrary emanating from persons now or formerly active in securities enforcement;[47] and one must recognize that the *SEC Annual Reports* may contain only the most prominent cases arising from year to year. In addition it is not altogether clear that the courts ought to view all cases of fraudulent and manipulative conduct as of the same gravity as cases of, for example, robbery. For some robbery cases may have involved substantial danger or even actual injury to the person of the victim. At any rate, before determining that the courts inevitably treat such offences leniently and arguing for further and exceptional measures, one ought to be sure that the crude figures do indeed represent a policy of favouritism or even an unconscious tendency in that direction.[48]

Even if there were a policy of favouritism or such a tendency, it is not clear to me that structural changes in the law are desirable.[49] The Criminal Code at present contains adequate maximum sentence provisions. It seems to me admirable that sentencing institutes should be held where the judges and others active in the field can discuss the problems involved in sentencing securities offenders. The notion of devising special sentences and special inhibitions on parole do not appeal to me. I would not in the least wish to argue against the position taken by some American

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president of the fund, five years to one vice-president, and up to two years for lesser officials); and a note of an even harsher sentence in, The Wall Street Journal, March 31, 1975, at 4, col. 3; and *see also* U.S. v. Sloan, 388 F. Supp. 1062 (S.D.N.Y. 1975); U.S. v. Ashdown, 509 F.2d 793 (5th Cir. 1975).

46 Browder v. U.S., 398 F. Supp. 1042 (D.C. Ore. 1975).

47 Sargent, *supra* note 35; Matthews & Sullivan, *supra* note 37; A. Sommer, *Sentencing*, 272 BNA Sec. Reg. & L. Rep., October 9, 1974, at A-12, arguing for more criminal prosecutions and judicial awareness of a need for substantial sentencing. There is a tendency to treat all white-collar offences as though they were a single entity; *see* Miller, *Respectability Helps if You're a Crook*, The Washington Post, July 7, 1974 at B1, B3. I doubt the validity of this approach.

48 I have argued these points more fully in L. Leigh, Politique et mesures pénals relatives aux infractions économiques (Council of Europe 1976).

49 *See* for a similar view, Sommer, *supra* note 47.

judges.[50] There is evidence to suggest that deterrence can work in this area. The position against which I would argue is that the white-collar offender ought to be assimilated in treatment to, if not placed under more onerous restrictions than, other criminals in respect of other crimes, without examining whether indeed the emphasis upon long sentences in general is appropriate. And even if one is obliged to accept an emphasis on long sentences as applicable to all manner of men, we ought surely before proceeding to consider exemplary penalties to be sure that there is in fact differential treatment in favour of the securities offenders and if there is such treatment, that it is due to structural factors such as the limited maximum sentence which could be awarded under the relevant legislation. Above all, we should be clear in our search for equality what the needs of deterrence and law enforcement generally are. There is something surely to be said for the unconventional wisdom of the court in a U.S. antitrust case which holds that deterrence is only one end of punishment, that prison is the exception which must be justified and that it should be reserved for cases of clear fraud.[51] We would agree with the U.S. federal judges who, considering the prospect of imprisonment to be a very severe punishment to business offenders, suggest that what is required is a reasonable certainty of relatively mild punishment. There is evidence to suggest that the publicizing of the available criminal penalties may itself have an effect.[52] There are of course professional swindlers who ought to be proceeded against with severity. In general moderate terms of imprisonment together with administrative sanctions would, we hope, suffice. In some cases where a fraudulent scheme is intricate and carefully worked out, affecting substantial numbers of people and involving much money, the court will have to consider both the effect on the community and the deterrent value of the sentence.[53] We should recall, however, that criminologists and others question the desirability of long sentences.

There is now much scepticism concerning the reformative potential of prolonged imprisonment. It is no longer agreed that short sentences are ineffective as deterrent. One must, of course, balance humanitarian considerations with the needs of deter-

50 *See* text accompanying note 31 *supra*.

51 U.S. v. Alton Box Co., 2 Trade Cas. ¶61,190 (E.D. Ill. 1976); Note also the attempt in the United States to devise a suitable sentence which will deter without imposing custodial sentence; Renfrew, *The Paper Label Sentences: An Evaluation*, 86 YALE L.J. 590 (1977).

52 *See* N. WALKER, SENTENCING IN A RATIONAL SOCIETY 59 (1969).

53 For a general account, *see id.* c. 4.

rence, the protection of the public, general deterrence and a denunciation of the offence.[54] The balance need not tilt on the side of very long sentences.[55] The question whether fraud offenders should be paroled should rest with the parole board. It should not be absolutely excluded for deterrent reasons. Nor should we engage in scapegoating; we cannot assume that all persons who violate the securities laws necessarily approximate to the stereotype of the Benthamite criminal. Here, as elsewhere, individualization of punishment is possible within limits.[56] Above all, it would be unfortunate if a policy were adopted of attempting to remedy deficiencies in systematic enforcement by the occasional sporadic imposition of very long sentences.

1. *Administrative Offences*

Another group of offences are typically regarded as administrative in character, such as requirements for the registration of persons or of securities, or bookkeeping or capital rules applicable to broker-dealers. Breach of these rules is made criminal even though no intent to defraud the public has been proven. Yet, as these requirements stand at the centre of regulatory schemes, they cannot be treated as of minor importance. Some of them are of crucial significance and failure to enforce them may jeopardize the entire system. Under section 5 of the U.S. Securities Act of 1933, for example, criminal penalties are provided for wilful violations of the registration requirement. This is a serious offence which, while requiring a wilful violation, does not in fact require intent to defraud but requires simply intent to do or not to do what the statute requires. The provisions of this section are relied upon increasingly by government in order to combat illegal securities distributions.

The registration requirements appear to be one of the most significant pressure points in this area. Violations of the section are not treated as mere technical violations, but as serious breaches of the law. Matthews argues that these should be regarded as substantial violations.[57] The public disclosure required by the registration provisions of section 5 are the backbone of federal securities laws. Emphasizing the significance of these provisions, he

54 *See in general* R. Cross, Punishment, Prison and The Public 98-108 (1971).

55 For a Canadian expression of this view, albeit in a somewhat different context; *see* R. v. Gorman, [1971] 3 O.R. 364 (C.A.); R. v. Johnson, [1971] 3 O.R. 744 (C.A.).

56 *See e.g.* R. Hood, Tolerance and the Tariff, (1974) (NACRO Paper No. 11); R. Vernet, Les interdictions professionelles 238-39 (1969); *cf. Department of Justice, Guidelines for Sentencing Recommendations under the Sherman Act*, 803 BNA Antitrust & Trade Reg. Rep., March 1, 1977, at A-7.

57 Matthews & Sullivan, *supra* note 37.

states that in some cases when an "inside" witness is not available to testify to the formation of a fraudulent scheme, the SEC is able to prosecute large-scale fraudulent distributions of grossly overpriced securities only under section 5, where the government's burden of proof is usually limited to showing that the defendants acted wilfully, that an interstate public offering occurred, and that no registration statement was filed with the commission. In such cases, a section 5 violation cannot be viewed as merely a technical violation.

One of the principal defects which Matthews notes with certain U.S. law reform proposals is a failure to provide sufficiently stringent penalties for misfilings. Such practices should be considered as extremely serious offences. It is perhaps anticipating to suggest that the same point occurs or may occur in Canada. But there seems in fact little reason to doubt the central importance of prospectus or insider provisions. It may be thought desirable ultimately to make them strict-liability offences with a due diligence defence and provide for stringent fines and imprisonment in cases where the defence is not made out. In other words, it may ultimately appear unwise either to stipulate wilfulness as a necessary constituent element of the offence, or to avoid making provision for the imposition of criminal penalties, including imprisonment, where a due diligence defence is not made out by an accused person. There are stringent strict-liability crimes in the Canadian statute book, generally made subject to due diligence defences and this seems a suitable precedent upon which to act.[58]

The same strict-liability approach is advocated in respect of other serious violations of important regulatory provisions and obligations, such as, for example, the duty to supervise salesmen and others working for a registered person.[59] Again, the activities of such persons are crucial to the maintenance of an orderly market in securities. It will be recalled that one of the principal reasons why Investors Overseas Services (IOS) collapsed in Germany with disastrous consequences was a failure on the part of the company to regulate the practices of its salesmen and its sales managers. It is not necessary to outline in detail the sorts of abuses which took place. It is, however, appropriate to point out that where duties of supervision are commonly neglected, opportuni-

58 *E.g.* Canada Water Act, R.S.C. 1970 (1st Supp.), c. 5, s. 31; and *see* National Commission on Reform of Federal Criminal Laws, Study Draft of a New Federal Criminal Code, s. 404(4) (1970) The Canadian provisions are collected and discussed in Leigh, *The Criminal Liability of Corporations and Other Groups*, 9 Ottawa L. Rev. 247 (1977) (author's submission to the Law Reform Commission of Canada 1973).

59 The crucial significance of control systems is stressed by Hanson, *Focus on Fraud*, The Financial Executive, March 1975, at 4.

ties to defraud investors will be taken. This seems to be another area in which we ought to provide for adequate penalties. It is, of course, not necessary that a fine or imprisonment be imposed in every case of, for example, failure to supervise. Most cases can no doubt be dealt with administratively. Where, however, there appears to be an unexplained and serious neglect of supervisory responsibilities, criminal proceedings may well be thought appropriate.[60]

The structure which I advocate is precisely the same as that advocated in relation to registration offences. There ought to be strict liability in order to enforce an affirmative duty. There ought to be a due diligence defence. There ought to be the possibility of imprisonment in cases where the failure to supervise is egregious. Such cases would include those where management was, in fact, aware of circumstances which ought to have caused it to discharge its supervisory responsibilities. The case would be *a fortiori* where management simply decided to do nothing about a well-known problem.

Certainly there should be a maximum in such cases considerably in excess of the $500 fine or six months' imprisonment often stipulated in strict-liability cases. It is noteworthy that much recent legislation, for example dealing with marine pollution, employs strict-liability offences, due diligence defences, with, in theory at least, condign penalties. I would recommend, therefore, that provisions which are significant to the scheme of regulation, ought to be regarded as fundamental and a deterrent structure of potential penalties should be provided for. In respect of particularly serious infractions, this will, one hopes, prove to be a meaningful approach to the problem. As I have noted, it will not be necessary to proceed by criminal prosecution in every case of violation.[61]

In addition, we should provide for a judicially imposed disqualification on persons from acting in the securities industry or, so far as the constitutional powers of the Parliament of Canada extend, acting in the management of a company, where the person concerned has been persistently in default in complying with any of the reporting requirements of securities or company legislation. Power to apply for a disqualification should rest in the Minister of Consumer and Corporate Affairs. The Federal Court should have power to disqualify for a period of at least five years. The power could be exercised by the court either consequent upon conviction or upon the imposition of an administrative sanction by a commis-

60 For an example of such a case *see* C. Raw, B. Page & G. Hodgson, Do You Sincerely Want to Be Rich? (1971).

61 The Quebec Securities Commission has already begun to act severely in such cases; *see*, *The Hard Cell*, The Financial Times (Toronto), May 30, 1977, at 31, col. 1.

sion. A similar provision now exists in section 28 of the U.K. Companies Act 1976.

2. *Defences*

A further problem concerns defences. We have argued for a due diligence defence in relation to regulatory offences. We suggest that in this connection provision should be made for a defence of reliance upon legal advice sought and tendered in good faith. At the moment U.S. courts hold that while reliance on an opinion by counsel may constitute a defence where crime requires specific intent, it affords no defence if only knowledge of the facts is required.[62] It should not be crucial to the defence that advice from a lawyer is wrong, unless indeed it is so obviously erroneous or so clearly based on an inaccurate appraisal of the facts as to permit the jury to speculate on the good faith of the accused.[63] On the other hand, reliance on the opinion of counsel ought not to constitute a defence where it is based upon assumptions which the accused person knew were erroneous either in whole or in part.[64] Such a provision applies under section 1517(b)(3) of the proposed *ALI Federal Securities Code*, but in an unduly laconic form, it being simply stated that:

> "(3) Advice of counsel is relevant but not conclusive in determining whether a person violates intentionally or recklessly..."

Apart from the rather skeletal character of this section, it is defective in not specifying whether it relates to mistake of fact or of law. It seems, however, that it must be the latter which is meant. The *ALI Code* does provide a "reasonable reliance" defence. The proposed Federal Criminal Code of the ALI, section 609, appears to be more restrictive, but this is not, I think, the case. Section 609 provides in part:

> "[A] person's good faith belief that conduct does not constitute a crime is an affirmative defence if he acted in reasonable reliance upon a statement of the law contained in:
> "(a) a statute or other enactment;
> "(b) a judicial decision, opinion, order or judgment;
> "(c) an administrative order or grant of permission; or
> "(d) an official interpretation of the public servant or body charged by law with responsibility for the interpre-

62 United States v. Hill, 298 F. Supp. 1221 (D. Conn. 1969); Kroll v. United States, 433 F.2d 1282 (5th Cir. 1970).
63 United States v. Crosby, 294 F.2d 928 (2d Cir. 1961).
64 United States v. Nardi, 330 F.2d 316 (2d Cir. 1964).

> tation, administration or enforcement of the law defining the crime."

The notes to the section suggest that in most instances it would be unreasonable for a layman to fail to consult a lawyer and he would not act in good faith if he failed to make full disclosure to the lawyer of all relevant facts.

A section of this sort could be adopted with advantage.[65] The Federal Criminal Code form is, I think, superior. It would validate action taken in reliance on a statement from the commission, as well as on reliance on the advice of counsel.

A further provision that might be included is section 1517(c)(3) of the *ALI Federal Securities Code*, which provides that a person may not be sentenced to imprisonment for violation of a regulation or order that is not a violation of the code apart from the regulation or order if the court is satisfied that he was not aware of the rule or order. Indeed under some U.S. federal statutes it is provided that a person who does not know of the rule or order may not be convicted at all.[66] The difficulty with that formulation is that it might conduce to ignorance. Proof of lack of knowledge of the rule can only mean proof of ignorance of the substance of the rule; that the conduct was contrary to law.[67] If the rule reflects a statutory provision, ignorance is no limitation at all.

A provision about which I feel grave doubt is section 1517(b)(4) which provides that a person may not be sentenced to pay a fine in an amount that would prevent him from making restitution or reparation to his victims. The notes give no indication of the reasoning behind this proposal. The notes to section 3302 of the proposed new U.S. Federal Criminal Code, the drafting model, also do not explain the provision but they do indicate a bias against fines as having no rehabilitative value. This view is certainly not universally shared.[68] In any event, it is not clear how any such provision would work in practice. Would it require imprisonment in cases where even a modest fine would preclude reparation? Would imprisonment not deprive an accused of the ability to make restitution or reparation? Are we in danger of maximizing the use of custodial penalties? I fear these possibilities and would recommend against any such provision, notwithstanding its plausibility.

We conclude this section with a few further remarks on the thrust of enforcement efforts. J.C. Sargent, a former member of

65 *See further*, G. Williams, Criminal Law, The General Part, s. 106 (1961); *see also* James, *supra* note 14.

66 ALI Federal Securities Code, Tent. Draft No. 3, s. 1303, Comment (5)(a).

67 United States v. Willey, 291 F. Supp. 989 (S.D. Tex. 1968).

68 *See* N. Walker, *supra* note 52, at 94-95, 109.

the SEC has, with others, voiced concern about certain enforcement practices.[69] One is a concentration upon administrative and civil remedies. The SEC is, in his view, inclined unduly to the use of consent decrees. The SEC favours this device because it saves resources. It assumes that such decrees have strong prophylactic effects. In Sargent's view the use of consent decrees may pose a threat to the efficacy and integrity of SEC enforcement procedures. The results may, he suggests, be:

> "(1) The SEC in many of its proceedings is never required to delve completely into the factual circumstances supporting its charges. It may, therefore, lack any realistic idea of what gave rise to the fraud, how it was perpetrated, or how it could have been anticipated, detected or prevented.
>
> "(2) Because of the economic pressures on many of those who are defendants in SEC proceedings, and because the sanction is generally minimal, many defendants will enter consent decrees as a matter of course even though they firmly believe they are innocent, or they are in fact innocent, of the SEC charges. The sanction, typically, is a short suspension of a broker's licence. It results in public censure of innocent persons.
>
> "(3) Because of the brevity of the procedure and the mildness of the ultimate sanction the consent decree does little to enhance the image of the SEC among members of the financial community. The SEC gets the reputation of administering only a mild slap on the wrist."

Sargent argues that the consent decree is successfully employed in minor cases, and, because it saves time and effort, is likely to induce the SEC to instigate more and more proceedings against relatively minor offenders which, he considers, creates a danger that the SEC will become obsessed with minutiae and will overlook major fraud cases. Thus, he argues, in the case of some larger frauds, the SEC failed to examine and verify material contracts. There was a failure to anticipate frauds which were signalled by rapid upsurges in corporate earnings per share in a short period, or by the anticipation of profits in the balance sheet giving rise to a false picture of liquidity. The implication is, he says, that the SEC is preoccupied with a multitude of minor infractions of the law. Such preoccupation will, it is suggested, alienate industry upon whose self-regulatory activities the scheme largely depends. Frivolous or unfair actions stimulate ill will.

69 Sargent, *supra* note 35; *see also Securities Enforcement: A Growth Industry - Cops Patrolling the White Collar Beat*, 397 BNA Sec. Reg. & L. Rep., April 6, 1977, at A-1.

A complaint is also levelled at courts which impose unduly light sentences in conspiracy to defraud cases. The validity of this latter point may be conceded. The rest of the reasoning will probably prove to be contentious.[70] It is no doubt true that a policy of concentrating on minutiae, allowing large frauds to escape attention, is bad. But has this happened? A further point must be recalled. So-called minor violations, such as breach of filing requirements, often go hand-in-hand with a fraudulent scheme. The enforcement of such rules may have a useful preventive effect. Nor is it necessarily the case, as we have noted, that a policy of seeking industry support by a nonprosecution policy, will stimulate industry to regulate itself. Undoubtedly there is a need for balance in prosecution policy and any Canadian commission will have to bear this in mind. I doubt that Sargent's propositions could be adopted as a guide to action without substantial qualifications.

B. CIVIL DAMAGE ACTIONS (GENERAL)

In the United States civil damage actions are regarded as a necessary means of enforcing the securities laws. Some such actions, in particular those dealing with misstatements in a prospectus, were expressly created by statute.[71] Others, such as actions for breach of section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, or section 14 of the Securities Exchange Act of 1934 dealing with proxy solicitations were developed judicially. Actions both individual and in some cases derivative were sustained on the broad footing that private enforcement of the legislation and rules provides a necessary supplement to commission action.[72] Both deterrence and compensation are recognized as appropriate purposes of the action. Indeed, actions under the Securities Act of 1933 are said to be primarily deterrent in character. But this substantial emphasis on deterrence has not induced American courts to award punitive damages for actions founded

70 It seems inconsistent with Matthews, *supra* note 18.

71 *E.g.* Securities Act of 1933, s. 11. There is a Canadian analogue under some of the corporation statutes of Canada and the provinces; *see e.g.* Canada Corporations Act, s. 79.

72 J.I. Case Co. v. Borak, 377 U.S. 426 (1964); Superintendent of Ins. of State of New York v. Bankers Life & Cas. Co., 404 U.S. 6 (1971); Kahan v. Rosenstiel, 427 F.2d 161 (3d Cir. 1970); Mariani, *Regulation of Fraud in Security Dealings*, 4 CUM.-SAM. L. REV. 94 (1973); note, *The Implication of a Private Cause of Action Under Title III of the Consumer Credit Protection Act*, 47 So. CAL. L. REV. 383 (1974); de Vita, *Civil Liability for Margin Violations - The Effect of Section 7(f) and Regulation X*, 43 FORDHAM L. REV. 93 (1974).

Some actions are primarily brought for rescission and where damages are seldom available, as under the proxy rules; *see* Note, *Private Enforcement of Federal Proxy Rules*, 15 WM. & MARY L. REV. 286 (1973).

upon breach of the statute.[73] In part the reluctance to award punitive damages is attributable to the fear that such damages, especially when awarded in a class action, might prove too severe. In part it was felt also that these could cause a disharmony between different statutes in the same field since, under section 28(a) of the Securities Exchange Act of 1934, punitive damages are expressly forbidden,[74] while under the Securities Act of 1933 this is not the case.

We treat private damage actions in this section, but private actions are also brought to obtain other remedies, for example rescission, and these are dealt with later in this paper.

The question whether such actions are essential or desirable in Canada depends upon the exigencies of enforcement. The need for civil liability as an aid to enforcement was felt keenly in the United States. American courts were ready to imply causes of action where these are not expressly provided for in the legislation. Of recent years there has been increasing attention to ordinary principles of statutory construction. The United States Supreme Court has laid down certain guiding principles to determine when civil actions will be implied. These are:[75]

(1) the plaintiff must belong to a class for whose especial benefit the statute was enacted;
(2) whether there is any indication of a legislative intent to create or deny such a remedy;
(3) whether a private right of action would be consistent with the underlying purposes of the legislative scheme;
(4) whether the plaintiff's cause of action was one traditionally relegated to state law.

In some cases the provisions of a statute militate clearly against the creation of a civil right of action, in particular when the statute both creates a right and a limited remedy *unoflatu*.[76] The Supreme

73 Feit v. Leasco Data Processing Equipment Corp., 332 F. Supp. 544 (E.D.N.Y. 1971); Fratt v. Robinson, 203 F.2d 627 (9th Cir. 1953).

74 Globus v. Law Research Service Inc., 418 F.2d 1276 (2d Cir. 1969); and *see* Hirsch & Lewis, *Punitive Damage Awards Under the Federal Securities Acts*, 47 NOTRE DAME LAW, 72 (1971); *see generally* Painter, *Civil Liabilities and Administrative Sanctions Under the Securities Act of 1933 in* SELECTED ARTICLES IN FEDERAL SECURITIES LAW 257, *supra* note 11.

75 Cort v. Ash, 422 U.S. 66 (1975); *see also* Pitt, *An SEC Insider's View of the Utility of Private Litigation Under the Federal Securities Laws*, 5 SEC. REG. L.J. 3 (1976); Lowenfels, *Recent Supreme Court Decisions Under the Federal Securities Laws: The Pendulum Swings*, 65 GEO. L.J. 891 (1977); Note, *A New Rationale for Implying Rights of Action and Section 7 of the Securities Exchange Act of 1934*, [1975] WASH. U. L. REV. 1201.

76 *E.g.* National R.R. Passenger Corp. v. National Assoc. of R.R. Passengers, 414 U.S. 453 (1972); Comment, *Private Rights of Action Under Amtrak and Ash: Some Implications*, 123 U. PA. L. REV. 1392 (1975).

Court has evinced caution in recent years, remarking for example that implied actions under Rule 10b-5 are an oak which has grown from a mere acorn. There has been a fear that such actions will be used to obtain blackmailing settlements.[77]

In the event, the Court has taken refuge in strict constructions of provisions of the securities laws. It has refused a private right of action in respect of tender offers on the footing first, that the legislation already provided adequate remedies and second, that the aggrieved tender offeror was not a person for whose especial benefit the legislation was enacted.[78] Lower courts have begun to treat the issue whether a private right of action is a necessary adjunct of enforcement very cautiously.[79] U.S. courts are not at present inclined to ignore arguments about supposed legislative intents. They are not longer inclined to rely simply on their view of what public policy requires.[80]

In Canada there are extensive statutory provisions concerning civil damage actions, but these generally do not apply in the absence of privity. The contrast with the United States is striking. It is largely explicable in terms of procedural advantages which may accrue from suit in the U.S. federal courts. In the United States the prohibition against the use of deceptive devices and contrivances in the sale or in the purchase and sale of securities opened up a potentially wide ambit of liability which was quickly exploited. It became clear that matters formerly within the purview of state corporation laws alone, if at all, could be comprehended within the sweep of federal statutes and rules. The procedural and other advantages which accompany suit in the federal courts ensured that federal legislation would be resorted to in order to found private damage actions.[81]

The scope of American law is wide. In some respects the criteria and extent of liability are still unsettled. This is true of insider trading and actions under Rule 10b-5 generally where all matters pertaining to the conditions of liability for damages have not been authoritatively settled. For example, the Supreme Court has held that *scienter* in the sense of intent is required for civil

77 Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

78 Piper v. Chris-Craft Industries, Inc., 97 S. Ct. 926 (1977).

79 *E.g.* Reddington v. Touche Ross & Co., 428 F. Supp. 483 (S.D.N.Y. 1977); Imperial Supply Co. v. Northern Ohio Bank, 430 F. Supp. 339 (N.D. Ohio 1976).

80 Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970); an action brought to set aside a merger which allegedly violated s. 14(a) of the Securities Exchange Act of 1934; Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951); Fratt v. Robinson, *supra* note 73.

81 *See* Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946) in which the theories underlying the implied action were set out. *See also* Note, *New Civil Liabilities Under Securities and Exchange Act Rules*, 14 U. Chi. L. Rev. 471 (1971).

recovery of damages under section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder.[82] It is not clear whether recklessness suffices, though the balance of authority indicates that it does.[83] Matters such as intent, reliance, materiality and causation form the staple of continuing judicial development. It is, for example, not clear whether in an action involving positive misrepresentation the plaintiff must show that he relied on the misrepresentation or whether materiality suffices.[84] The standard of materiality at any rate has been clarified to mean that the omitted fact would have been viewed by the reasonable investor as actually significant. It is not a mere matter whether it might have had an effect on him.[85] We do not propose to go further into U.S. substantive law. It suffices to point out that the existence of extensive anti-fraud provisions cast in terms of the effect or characteristics of conduct has given a tremendous impetus to development.

By contrast the situation in Canada is uncertain and extensions of liability have in general to be the creations of statute. Thus Ontario Bill 30 (the latest available reform measure) expressly specifies both criminal and civil liability for insider trading.[86] Both the civil cause of action and the available defences are specified. The provision would apply to insiders who purchase or sell securities of a reporting issuer and would seemingly apply only to the other party to the contract. The clause may be rather obscure.

It is not desired to compare the United States and Canadian systems at this stage. It is perhaps enough to say that our provisions are apparently relatively narrowly drawn and unlikely to benefit from the wider constructions given to their U.S. counterparts. In addition, however, U.S. courts and no doubt Canadian courts as well are likely to be wary of the great economic consequences of wide, implied, causes of action.[87] This concern as we

82 Ernst and Ernst v. Hochfelder, 425 U.S. 186 (1976).

83 Sanders v. John Nuveen & Co., [1977-1978 Transfer Binder] CCH Fed. Sec. L. Rep. ¶96,030 (7th Cir. 1977); Sundstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033 (7th Cir. 1977); Wright v. The Heizer Corp., 560 F.2d 236 (7th Cir. 1977).

84 Materiality is enough in omissions; *see* Affiliated Ute Citizens of Utah v. United States, 92 S. Ct. 1456 (1972). As to misrepresentations, the issue is confused; Blackie v. Barrack, 524 F.2d 891 (9th Cir. 1975) suggests that materiality is enough in all cases but it is not clear whether this is correct. *See* PLI, Seventh Annual Institute on Securities Regulation (R. Mundheim, A. Fleischer Jr., B. Vandegrift eds. 1977) where the matter is extensively discussed.

85 T.S.C. Industries Inc. v. Northway Inc., 96 S. Ct. 2126 (1976).

86 Ontario Bill 30, cl. 77(1); on the duty of disclosure *see* Green v. Charterhouse Group Canada Ltd., 12 O.R. (2d) 280 (C.A. 1976).

87 Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975); *see* in a more expansive vein SEC v. Texas Gulf Sulphur Corp., 401 F.2d 833 (2d Cir. 1968); Shapiro v. Merrill Lynch, Pierce, Fenner & Smith Inc., 495 F.2d 228 (2d Cir. 1974).

have seen underlies some of the recent United States Supreme Court decisions.

The difference in substantive law only partially explains the lack of civil actions in Canada. For, in some respects, American and Canadian statutes do appear to cover the same ground and the resulting civil actions which have developed in the United States disclose that even under a relatively narrow statutory regime there is room for supplementary civil actions.

1. *Traditional Civil Actions: Prospectuses*

Certain heads of liability are traditional both here and in the United States. The first of these is liability for a misleading prospectus.[88] Clause 129 of Ontario Bill 30, the most recent Canadian proposal, which is structurally similar to section 80 of the Canada Corporations Act, provides in part:

> "129. (1) Where a prospectus together with any amendment to the prospectus contains a misrepresentation, a purchaser who purchases a security offered thereby shall be deemed to have relied on such misrepresentation and has a right of action for rescission or damages against,
> "(a) the issuer or selling security holder;
> "(b) each underwriter of the securities who is required to sign the certificate required by section 60;
> "(c) every director of the issuer at the time the prospectus or the amendment to the prospectus was filed;
> "(d) every person or company whose consent has been filed pursuant to a requirement of the regulations but only with respect to statements or reports that have been made by them; and
> "(e) every person or company that signed the prospectus or the amendment to the prospectus other than the persons or companies included in clauses a to d.
> "(2) No person or company is liable under subsection 1 if he proves that the purchaser purchased the securities with knowledge of the misrepresentation."

The coverage thus achieved is similar to that contained in section 1403 of the *ALI Federal Securities Code.*

Clause 129 then proceeds to capitulate defences. It distinguishes between different classes of defendants. Thus subsections (3) and (4) provide:

> "(3) No person or company, other than the issuer or

88 Such provisions leave ultimately from the Directors Liability Act 1890, 53 & 54 Vict., c. 54.

selling security holder, is liable under subsection 1 if he proves,

"(a) that the prospectus or the amendment to the prospectus was filed without his knowledge or consent, and that, on becoming aware of its filing, he forthwith gave reasonable general notice that it was so filed;

"(b) that, after the issue of a receipt for the prospectus and before the purchase of the securities by such purchaser, on becoming aware of any misrepresentation in the prospectus or an amendment to the prospectus he withdrew his consent thereto and gave reasonable general notice of such withdrawal and the reason therefor;

"(c) that, with respect to any part of the prospectus or the amendment to the prospectus purporting to be made on the authority of an expert or purporting to be a copy of an extract of a report or evaluation of an expert, he had no reasonable grounds to believe and did not believe that there had been a misrepresentation or that such part of the prospectus or the amendment to the prospectus did not fairly represent the statement of the expert or was not a fair copy of the extract from the report or evaluation of the expert, or

"(d) that, with respect to any part of the prospectus or the amendment to the prospectus purporting to be made on his own authority as an expert or purporting to be a copy of an extract from his own report or evaluation as an expert, he had, after reasonable investigation, reasonable grounds to believe and did believe that there had been no misrepresentation or that such part of the prospectus or the amendment to the prospectus did not fairly represent his statement as an expert and on becoming aware of such use of his statement or report or evaluation he forthwith advised the Commission and gave reasonable general notice that such use had been made and that he would not be responsible for that part of the prospectus or the amendment to the prospectus.

"(4) No person or company, other than the issuer, is liable under subsection 1 if he proves that, with respect to any part of the prospectus or the amendment to the prospectus not purporting to be made on the authority of an expert and not purporting to be a copy of an extract of a report or evaluation of an expert, he had, after reasonable investigation, reasonable grounds to believe and did believe that there was no misrepresentation.

Subsection (5) then proceeds to specify that the standard of

reasonableness shall be that required of a prudent man in the circumstances of the case. Section 1403(g) of the *ALI Federal Securities Code* specifies with greater particularity the matters to be taken into account in determining reasonableness. It provides:

> "1403(g) *Standard of reasonableness.* In determining what constitutes reasonable investigation or care and reasonable ground for belief under section 1403(f)(3), the standard of reasonableness is that required of a prudent man under the circumstances, including with respect to a defendant other than the registrant (1) the type of registrant, (2) the type of defendant, (3) the office held when the defendant is an officer, (4) the presence or absence of another relationship to the registrant when the defendant is a director or proposed director, (5) reasonable reliance on officers, employees, and others whose duties should have given them knowledge of the particular facts (in the light of the functions and responsibilities of the particular defendant with respect to the registrant and the filing), (6) the type of underwriting arrangement, the role of the particular defendant as an underwriter, and the accessibility to information with respect to the registrant when the defendant is an underwriter, and (7) whether, with respect to a fact or document incorporated by reference, the particular defendant had any responsibility for the fact or document at the time of the filing from which it was incorporated."

It is submitted that the greater particularity of the American proposal is not in fact an advantage. The criteria in spite of their definite appearance are rather nebulous and I doubt the wisdom of giving greater currency to the doctrine that directors can reasonably rely on officers than it has already.

Damages are limited under subclause (5) of Ontario Bill 30 in respect of an underwriter by providing that no underwriter is liable for more than the total public offering price represented by the portion of the distribution underwritten by him. An identical provision appears as section 1403(h)(1)(C) of the *ALI Federal Securities Code*. In Ontario there is a provision that in no case shall damages exceed the price at which securities were offered to the public. The *ALI Federal Securities Code* contains a complex formula because it deals also with liability for misrepresentations in annual reports. The Securities Act of 1933 provides, as does the Bill that the amount recoverable shall not exceed the price at which the security was offered to the public.

Clause 130 of the Ontario Bill contains a right of action for rescission and damages in connection with misrepresentations in

a takeover bid circular. The structure of the section is essentially the same as that of the prospectus liability section. The action lies against the offeror, its directors at the relevant time and each person who signed a certificate in the circular. Liability in damages is also stipulated against every director or officer who signed a director's circular sent to the offerees of an offeree company. The structure of defences including withdrawal of consent, reasonable investigation and reasonable grounds for belief in the truth of the representation and the like, is the same as that of the prospectus section. The clause applies in favour of offences only and not in favour of a competing offeror.[89]

Clause 132 of Ontario Bill 30 provides for rescission and damages for a number of trading violations. Liability is provided in favour of the traders' purchaser or offeree. The provisions concerned are:

(1) section 54, trading without prospectus where a prospectus is required;
(2) section 66, concerning distribution in defiance of the waiting period restrictions;
(3) section 72, concerning the obligation to deliver a prospectus;
(4) section 73 (4), (5), (7), concerning restrictions to the exemption from prospectus provisions;
(5) section 95, concerning the form of a take-over bid circular and the requirement that it accompany a take-over bid.

This section finds its analogue in section 1402(a) of the *ALI Federal Securities Code*. By contrast, section 1402(b) of the *ALI Code* is wider in that it catches transactions in the impersonal market where these take place following specified violations of the formal requirements of the code.

2. *Insider Trading*

Civil actions for breaches of the insider trading provisions already exist in U.S. law and in Canada under the British Columbia Securities Act. The most recent Canadian proposal is found in clauses 77 and 130 of Ontario Bill 30. The Ontario Bill does not confer a right of action for manipulation as such. It makes provision in clause 77 forbidding any person or company from purchasing or selling the securities of a reporting issuer with knowledge of a material change in the affairs of such issuer that he or it knew or reasonably ought to have known had not been generally disclosed or from informing another person or company about such a

89 The result is the same as that in Piper v. Chris-Craft Industries Inc., *supra* note 78.

material change other than in the necessary course of business before it has been so disclosed. Section 128 then provides:

> "128. (1) Every person or company that sells or purchases the securities of a reporting issuer with knowledge of a material change with respect to such issuer that has not been generally disclosed is liable to compensate the purchaser or vendor of such securities for damages as a result of such trade unless,
>
> "(a) such person or company has reasonable grounds to believe that such material change has been generally disclosed; or
>
> "(b) such material change was known or ought reasonably to have been known to the purchaser or vendor.
>
> "(2) Any person or company who has access to information concerning the investment program of a mutual fund that is a reporting issuer and uses that information for his or its direct benefit or advantage to purchase or sell securities of an issuer for his or its account where the portfolio securities of the mutual fund include securities of that issuer is accountable to the mutual fund for any benefit or advantage received or receivable as a result of such purchase or sale.
>
> "(3) Every person or company referred to in subsection 1 that is also an insider of the reporting issuer, or an associate or affiliate of such insider, is, in addition to the liability imposed by subsection 1, accountable to such issuer for any benefit or advantage received or receivable by such insider or associate or affiliate."

It seems probable, as we have argued, that subclause 1 is restricted to privity situations. The provision speaks of compensating the purchaser or vendor of *such* securities, meaning thereby, it is submitted, securities actually purchased or sold by the insider in violation from or to the potential plaintiff. It does not purport to confer an action upon persons who can show only a temporal rather than a causal connection between dealing and loss. It is submitted, therefore, that the ban on insider trading in section 77 is wider than the right of action conferred by section 128(1). Subsection (3) enacts the rule developed by U.S. courts that the misuse of insider information by officers of a corporation constitutes a misappropriation of a corporate advantage for which the insider is liable on restitutionary principles.[90]

Two other interesting models of insider trading provisions may be referred to. The first is the U.K. Companies Bill of 1973

90 Diamond v. Oreamuno, 24 N.Y. 2d 494, 248 N.E. 2d 910 (1969).

which lapsed on the fall of the Heath government. It was a bill directed primarily towards penalizing insider trading by the criminal law but provided a civil cause of action. Clause 15(3) would have created a civil right of action where an insider with confidential information deals or procures another person to deal in securities to which confidential knowledge relates. The defendant would have been liable to compensate the plaintiff, the other party to the transaction, who was not in possession of the information for any loss sustained by that party by reason of any difference between the price at which the securities were dealt with and the likely price had that information been available. Again, the provision seems to have been intended to refer only to situations in which the parties were in privity, wider situations being left to the criminal law.

The *ALI Federal Securities Code*, section 1402, provides a right of action for insider trading where the defendant has sold or bought a security of an issuer if he knows a fact of special significance with respect to the issuer, unless he believes and has reasonable ground to believe that the fact is generally available, or, if the other party to the transaction or his agent is identified, that he believes and has reasonable ground to believe that that person knows it or that that person in fact knows it from the insider or otherwise. "Insider" is defined to include a broad range of persons, the issuer, its officers, those of subsidiaries, etc. Liability goes beyond the privity situation. Civil liability applies whether the transaction is or is not effected in the market.[91] In order to prevent huge awards of damages there is a prorationing provision in section 1409 and a limitation of damages provision in section 1402(2) which applies where transactions are effected in the market and limits the defendants damages by reference to the amount of securities which the defendant bought or sold. Thus, where in essence the case rests on "poisoning the market" the global total of damages is subject to an arbitrary upper limit in order to avoid colossal damage awards.

In a case where the parties have been brought into privity by a communication expressly and explicitly directed from one to the other the boundaries of liability are easy to determine and the compensatory purpose of the civil action can plainly be seen to be vindicated.[92] But in a case in which the transactions are market transactions, this is not always the case.

91 ALI Federal Securities Code, s. 1402(a), (b).

92 List v. Fashion Park Inc., 340 F.2d 427 (2d Cir. 1965), *cert. denied*, 328 U.S. 811 (1965). The scope of the action created by the Canada Corporations Act, s. 100.4 which reproduces the present Ontario s. 113, is altogether uncertain. It clearly provides for liability to the insider's corporation on restitutionary principles. *Qua* other persons, an insider who trades on the basis of confidential information is liable for

The difficulty arises both in cases of misrepresentation by affirmative false statement and in cases of misrepresentation by omission. If, for example, insiders trade on the basis of a positive misstatement in a press release, their liability in theory extends (provided that any other qualifying conditions such as intention or negligence are met) to every person who dealt during the period in which such release can be assumed to have affected the market. The extent of such liability is potentially enormous, for, if the basis of liability essentially rests in poisoning the market, the insider must be liable to everyone who traded therein and suffered loss whether or not he actually came into contact with the insider or actually read or otherwise became acquainted with the material false information. Historically, U.S. courts, mindful of the compensatory basis of civil liability and anxious to set some bounds to liability, have insisted that it be shown that the defendant's transgression caused the plaintiff's loss.

Other limitations to recovery have also been suggested, turning on the *scienter* necessary to found an action for damages as distinct from a SEC injunction proceeding.[93] The Supreme Court, relying on similar considerations, has norrowly construed the "in connection with" clause of Rule 10b-5.[94]

3. *Manipulation*

Similar considerations arise if it is considered appropriate to create a civil action for market manipulation. No such action presently exists in England or in Canada. The *ALI Federal Securities Code* does however propose to create one. It founds in part upon existing actions. Section 1408 refers to manipulation by representation or trading.[95] It confers an action for damages upon a person

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any *direct* loss suffered by that person as a result of the transaction unless the information was known or ought reasonably to have been known to that person. Whether it was intended to import the wide jurisprudence under s. 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, is uncertain. In Green v. Charterhouse, *supra* note 86, which did not involve these wider issues, the court cautioned mildly against relying uncritically on U.S. precedents, noting that the words of the statute are to be applied according to their plain meaning.

93 SEC. v. Texas Gulf Sulphur, *supra* note 87; and *see* Ernst and Ernst v. Hochfelder, *supra* note 82.

94 Blue Chip Stamps v. Manor Drug Stores, *supra* note 87; Thomas v. Roblin Industries, 520 F.2d 1393 (3d Cir. 1975).

95 The section refers to ALI Federal Securities Code, ss. 1308, 1309. Section 1308 prohibits manipulation by touting, wash sales and matched orders, manipulation by trading which means engaging in a series of transaction to affect share prices artificially, and buying during a distribution which refers to certain acts of buying by a secondary distributor or underwriter or other person who is participating or financially interested in a distribution. Essentially the culpable acts are buying for

who bought or sold a security of the class involved after the violation but only on proof that he bought or sold at a price affected by the violation if he bought or sold more than thirty days after the last act constituting the violation. In other words, if he buys after the expiration of the thirty-day period he must prove that his purchase price was affected by the violation. The defendant has a defence if he proves that the plaintiff bought or sold with knowledge of the violation. The measure of damages is reduced to the extent that the defendant proves that the violation did not cause the price differential. An upper limit to damages applies where the manipulation refers to buying during a distribution, or to a breach of the stabilization rules. By subsection (e) a person who violates the antimanipulation provisions noted above is liable to any person other than a buyer or seller of the security involved for any loss caused by the violation. This provision puts a burden of proof on the plaintiff who must prove the causal connection.

The justification for placing an arbitrary maximum upon damages for breaches of the buying during a distribution or stabilization rule provisions is their difficult and technical character.

4. *Other Possible Actions*

The *ALI Federal Securities Code* suggests an action based upon nonfraudulent breaches of regulatory requirements. Section 1401 deals with such liability and is divided into transactions not effected in the markets and transactions effected in the markets. Among the unlawful practices struck at are purchases or sales of securities for which an offering statement or prospectus is required and none is made available,[96] section 509(b) referring to distribution statements, etc. The relief afforded is rescission or damages. The section is said to be superior to existing law in that:

(1) market sales are covered adequately;
(2) a damages scheme is involved to limit the defendant's liability in market sales. This aspect has been mentioned in accordance with manipulation and insider trading;
(3) not every trivial breach of a regulatory requirement will found liability.

Provision is also made in section 1403 for actions based on false registration statements, offering statements, and reports. A plaintiff may bring an action if, in the case of an offering state-

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oneself or for an account in which one is broadly interested beneficially. Section 1309 refers to contravention of commission regulations concerning stabilization.

96 *See id.* s. 503.

ment, he bought a security of a class covered thereby after its effectiveness. Section 1404 deals with other filings. Provision is made for reliance. Section 1403(e) confers a defence on a person who proves that the defendant bought or sold with knowledge of the misrepresentation, the fact or document omitted or not incorporated by reference, or a fact of special significance which should have been disclosed by reason of another provision of the code.[97] There is a defence of correction or lack of negligence. The defendant, by section 1403(d)(1) has a defence if he proves that the misrepresentation or omission was corrected by a later filing. This defence is not available against a plaintiff who dealt before the correction became generally known or who justifiably relied on the misrepresentation or omission. Reliance on an omission is proved by reliance on a particular filing or document, and reliance on either a misrepresentation or an omission may be proved without proof that the defendant read a particular filing or document. A defendant has a defence to an action based on a culpable failure to correct a report if he proves that he did not know and had no reason to believe that there was a culpable failure to correct.[98] Again, there is a limitation of damages provision in section 1403(3)(h).

The section deals with offering statements, registration statements and annual reports. The limitation provision seeks to ensure that greater potential liability will not be imposed for registration statements than for offering statements, since greater liability would, the reporter states, be illogical. He states there must also, given the availability of class actions, be some maximum to prevent the possibility of utterly disproportionate recoveries for material, but nevertheless insubstantial, lapses. It is not clear how a lapse could be both insubstantial and material. The problem is how to encourage the class action, facilitate its use by avoiding proof of causation and yet avoid destructive recoveries, some of which may in respect of some class members, be windfall benefits. The question whether arbitrary limits to recovery is the best way of tackling the problem is dealt with below. But at the risk of some discontinuity in exposition, the deterrent aspect of the private damage action must again be stressed.

97 *See id.* s. 1303(c); a fact is material if, broadly, in addition to being material it would be likely to be made generally available to affect the price of securities or if a reasonable person would attach special importance to it in making his decision.

98 Despite a misprint in ALI Federal Securities Code, Reporter's Revision of Tent. Drafts Nos. 1-3 which refers to s. 1303(d), it seems clear that s. 1304(d) is meant.

5. *Actions Based upon Registrant's False Filings Generally*

Section 1404 of the *ALI Code* deals with other and residual cases including secondary distributions – unless the secondary distributor controls the issuer or underwriter in which case he will be liable under section 1408. Only the registrant (subject to section 1419 dealing with aiders and abettors) is liable under the section. The matters comprehended are: purchase or sale of a security of a registrant other than a security of a class covered by a contemporaneous registration statement; or in the case of a filing not comprehended within section 1403(a), the purchase or sale of a security of a registrant after the filing. The measure of damages is again limited. The section seeks to come to grips with the difficult question of open-ended liability either with respect to miscellaneous false filings or with respect to false press releases or other forms of publicity, for example a report to stockholders or a speech. Defences are provided; for example, proof by the defendant that the plaintiff bought or sold with knowledge of the deceptive act or misrepresentation, or where the plaintiff proves only a misrepresentation and the defendant proves that he did not believe and had no reason to believe that there was a misrepresentation (section 1402), or where, as in section 1403(d), there was a timely correction. The measure of damages is again limited as in section 1403(h) but in accordance with that section, not where there has been an intentional misrepresentation. The great strength of the section as revised by the Reporter lies in allowing a compensatory action broadly based on fault. The culpable state of mind is *scienter*, defined in section 296AA as a representation made knowingly or recklessly as to its falsity or knowing that it does not have the factual basis which it is implied that it has. Seemingly, liability for negligence *stricto sensu* is excluded by the formulation. Its weakness lies in imposing limits on individual compensation which can only be sustained on broad grounds of public policy.

6. *Actions Based upon False Distribution Statements*

Section 1405 of the code refers to certain contents of a distribution statement. The section renders the secondary distributor and every underwriter liable in the same way as a registrant and underwriter under clause 1403.

7. *Actions Based upon False Publicity*

Section 1406 applies to a violation of section 1304(c). That section makes it unlawful to make, etc., a representation in a press release if it is reasonably foreseeable that the deceptive act will induce other persons to buy, sell and hold securities. On proof of a violation by means of a misrepresentation known by the violator to be so, the violator will be liable to a person who bought or sold a security of the registrant after the violation. It is a defence to prove that the plaintiff bought or sold with knowledge. There is also a defence of prompt correction. Again, there is an upper limit to liability. Like section 1404 on which it is modelled this section insists on *scienter* as a prerequisite to liability. It is similar in imposing upper limits to recovery. Like the rest of the scheme this reflects a preference for the conservative views expressed in *Texas Gulf Sulphur* and fears of the huge recoveries possible in class actions.

8. *Churning*

Section 1410 applies to a broker or dealer who violates the churning section (section 1306) and renders him liable to the customer in an action to recover commissions or profits, any interest paid by the customer and whatever additional items of damages the court may allow; *e.g.*, taxes, income or capital appreciation and trading losses. The latter recovery was indeed allowed at common law in New York.[99] One would expect it to be allowed in Canada under general principles of agency. It could well appear in our legislation.

9. *Failure to Register on Demand*

Section 1411 refers to section 501(b) of the code, filing on demand by an issuer of offering and registration statements. In addition to requiring compliance, the court may award damages for any loss caused by the violation.

10. *Proxy Solicitations and Tender Requests*

Section 1412 refers to existing or apprehended violations of the proxy solicitation and takeover bid sections (sections 602, 603, 1301) but not where an action already lies under sections 1402–06. The court may enjoin violations, require compliance, enjoin the use

99 Pierce v. Richard Ellis & Co., 310 N.Y.S. 2d 266 (1970).

of proxies solicited or given in violation or the consummation of action authorized by their use, or set aside action so consummated, or award damages against a violator for any loss caused by his violation, or grant other appropriate relief, preliminary or final, including a combination of the types of relief specified in the section. In order for damages to be awarded, the plaintiff must prove his loss.[100] By subsection (c) added by the Reporter in the Revision volume a buyer or seller may not obtain damages under this section to the extent that he has an action under sections 1402–06 inclusive as a result of conduct actionable under this section. This provision is intended to avoid overlap. One who buys or sells in the market in reliance on false literature that violates one of the specified sections must sue under them.

11. *Liability for Short-Term Insider Trading*

Section 1413 of the code refers to section 604(a), dealing with insiders, 10% holders, etc. It is intended to be the successor to section 16 of the Securities Exchange Act of 1934. Its purpose is to prevent the unfair use of inside information. It accomplishes this purpose by conferring an action upon an issuer to recover profits from short-swing purchases and sales within a six-month period. Certain transactions of gift, pledge and loan are excepted. There is a provision against double liability. The commission has an exemptive authority. The dispute as the Reporter points out, concerns whether there should be an arbitrary liability of this character, especially given (in the United States) the broad anti-fraud jurisprudence under Rule 10b-5. In respect of the latter it has been argued that the rule has rendered obsolete the concept of automatic recapture of certain short-term profits of certain insiders. The Reporter advocates its retention on grounds of symbolic significance. [101] He notes also that the section strikes at the opportunity for abuse, especially where there is such opportunity in the event of a sale *after* insider status is achieved. One's initial reaction is to suggest that if this stringency is necessary on prophylactic or deterrent grounds, it should be retained. Mere symbolism is not, in my submission, enough. The provision against double liability which enables the recoverable profit to be reduced by damages, interests or costs paid to purchasers, etc., seems appropriate given that the section imposes liability without fault.

100 *See* ss. 1412(a), (b), (b)5 allowing damages for loss "caused" by his violation; the section codifies Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970); s. 1412(a)(1) codifies J.I. Case Co. v. Borak, 377 U.S. 426 (1964).

101 ALI Federal Securities Code, Tent. Draft No. 2 at 133 (1973).

12. *Credit Provisions*

Section 1414 refers to violations by lenders of regulations limiting the amount of permissible credit. I do no more than mention it here since the regulations have not as yet been drafted. There seems a clear rule under U.S. legislation that a customer has a private right of action against a person who unlawfully provides finance for him. The action is one of protecting the innocent "lamb" attracted to profits with low capital investment. One can see the deterrent purpose of the action without finding the prospect of customers suing lenders an attractive one, at any rate where the lender did not engage in high-pressure tactics. But if the thrust of the action is regulation, the private action to which the *in pari delicto* rule does not apply has its attractions.

a. *Breach of Fiduciary Duty*

Breach of fiduciary duty regarding investment companies founds an action which would include taking excessive compensation. It is buttressed by a SEC action created in part XV which will largely incorporate section 1415 of the *ALI Code* by reference. The action will attract injunctive relief under section 1515(b).

13. *Civil Actions Implied from Rules of Self-Regulatory Agencies*

United States courts have implied civil actions from breaches of the rules of self-regulatory agencies. The rule must be shown by the plaintiff to be of such a nature that its violation ought to give rise to a private cause of action.[102] In the *Buttrey* and *Bache* cases the Court of Appeals held that where the function of the rule is to protect the public so that the rule is not a mere matter of domestic housekeeping a civil action may lie. In *Buttrey* there was more than a mere violation of a rule; the violations amounted to conduct inconsistent with just and equitable principles of trade and were indeed said to be tantamount to fraud. Later cases, in the wake of *Cort v. Ash*, have enquired closely into whether the legislature intended an action, and evinced a reluctance to increase Federal Court jurisdiction, or to contemplate liability when massive damages may result.[103] In the *Bache* case it is said that the case for

102 Colonial Realty Corp. v. Bache & Co., 358 F.2d 178 (2d Cir. 1966), *cert. denied*, 385 U.S. 817 (1966); and *see* Piper, Jaffrey & Hopwood Inc. v. Lake, 399 F. Supp. 292 (S.D. Iowa 1975); Van Gemert v. Boeing Corp., 520 F.2d 1373 (2d Cir. 1975).

103 422 U.S. 66 (1975); and *see* Lang v. H. Hentz & Co., 418 F. Supp. 1376 (N.D. Tex. 1976); Utah State Univ. v. Bear Staines & Co., 549 F.2d 64 (10th Cir. 1977); Warren v. Bokum Resources Corp., 414 BNA Sec. Reg. & L. Rep., August 3, 1977 at A-1 (D.N.M.

implying a novel cause of action would be strongest when the rule imposes an explicit duty unknown to common law.[104] In such a situation, in the United States, the result would be both an extension of substantive law and of federal jurisdiction. Among the rules which, it is suggested, exist for the protection of the public, are rules restricting the pledge of customers' securities, forbidding affiliations with bucket shops, limiting the discretion which a member may have over a customer's account, and which prohibit excessive trading, manipulative practices and the circulation of rumours. There may well be further rules, instituted as a matter of good business practice, which bear this public connation though the tendency of the courts as we have noted is against such an extension.[105] It has been argued that once it has been shown that violation of the rule caused the loss and that the rule alleged to have been violated was for the protection of investors, liability should follow without any requirement of showing that the violation was tantamount to fraud.[106] It has indeed been intimated that a failure by a stock exchange to enforce its own rules may give rise to a civil action, particularly if it can be shown that the stock exchange's failure caused the plaintiff's loss and the appropriate standard of culpability can be proven against the exchange. Courts have said that an exchange is not under a duty to scrutinize every transaction but may be liable for losses occasioned by a general deficiency in the enforcement of its rules.[107] The fault requirement for liability has not yet been authoritatively determined.[108]

If it is desired to provide for actions founded on the breach of the rules of self-regulatory agencies, it would be preferable to do so expressly by statute. In the light of *Vapor Canada Ltd. v. MacDonald*[109] any such provision will have to be carefully drafted in order to display criteria which make it a necessary part of a regulatory scheme. We might therefore consider a provision like section 1416 of the *ALI Federal Securities Code*. That section provides that a person who violates a rule of a national securities exchange or of the NASD provided that it is a rule which comes

1977); Zagari v. Dean Witter & Co., [1976-1977 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 95,777 (N.D. Cal. 1976).

104 *See also* Plunkett v. Dominick, 414 F. Supp. 885 (D. Conn. 1976).

105 *See* cases cited at note 102 *supra*.

106 Allen, *Liability Under the Securities Exchange Act for Violations of Stock Exchange Rules*, 25 Bus. Law. 1493 (1970).

107 Pettit v. American Stock Exchange, 217 F. Supp. 21 (S.D.N.Y. 1963); Butterman v. Walston & Co., 387 F.2d 822 (7th Cir. 1967), *cert. denied*, 391 U.S. 913 (1968).

108 *See further* Swanburg, *Implied Civil Liability Arising from Violation of the Rules of the National Association of Securities Dealers*, 8 Loy. L.A.L. Rev. 151 (1975).

109 7 N.R. 477 (S.C.C. 1976).

within the section, will be liable to any customer for a loss caused by the violation. Power is given to the SEC to determine whether the rule is to come within the section or be definitively excluded from it. If it is not excluded, the court may imply the action as a matter of federal common law. The enactment of a similar provision, limited by the criterion of a commission decision that it does come within the section would, it is submitted, meet the constitutional criteria and enable the commission to control the spread of litigation in the public interest.

14. *Implied Actions Generally*

A further provision worth considering is that of section 1417 of the *ALI Federal Securities Code* which enables a court to recognize a private action based on a violation of the provisions of the code. The section has the merit of specifying what considerations should govern the court in implying a cause of action. These are:

(1) that such an action not be inconsistent with the conditions or restrictions in any of the actions expressly created;
(2) that the provision be intended to protect the class of persons to which the plaintiff belongs against the kind of harm alleged;
(3) the plaintiff satisfies the court that under the circumstances the remedy sought and the deterrent effect of recognizing the action would not be disproportionate to the violation;
(4) in certain cases where potential liability is very wide; those which resemble the cases where the code proposes an upper limit to damages, a comparable limit is placed on damages.

The criteria are not dissimilar to those in *Cort v. Ash*[110] save that the court need not inquire whether the matter is analogous to matters dealt with by state law. In the interests of constitutional prudence it would be wise to specify as a negative criterion that an action in Canada should not be implied where the subject matter is adequately dealt with as a matter of provincial common law.

It is submitted that no constitutional impediment to the creation, or indeed the implication, of private rights of action in aid of securities regulation arises. This comment assumes, however, that securities regulation in its widest aspects is a topic competent to the Parliament of Canada. That issue forms the subject of a separate paper. *Prima facie*, however, Parliament could rely upon the general power in section 91 of the BNA Act 1867, the commerce power in section 91(2); and the criminal law power in section

110 422 U.S. 66 (1975).

91(27), the latter having been quite liberally construed since *Proprietary Articles Trade Association v. A.G. of Canada*.[111]

It has been suggested that constitutional difficulties arise. Professor Alexander writes:[112]

> "In a country of divided legislative jurisdiction like Canada, another factor influencing the courts in their pursuit of legislative intention is the constitutional difficulty of finding a Parliamentary intention to confer civil causes of action. Such an intention, if it were found to exist, would in most cases be unconstitutional; hence, the courts are unlikely to find such an intention when to do so would be to render the particular statute *ultra vires*."

The argument is as unimpressive as the authority cited in its support. If Parliament were simply to create civil actions at random the legislation would be *ultra vires* either because the legislation would be in relation to property and civil rights, a field reserved to the provinces under section 92(13) of the BNA Act 1867, or because it could not be said to relate to any validating head of federal power.[113] But simply to focus on whether a civil action is created is to confuse subject matter and aspect. With isolated exceptions Canadian courts have considered that there is no constitutional impediment to the creation of civil actions in aid of otherwise valid federal legislation. The better view is that such actions are perfectly valid measures passed in aid of enforcement. They share the aspect of the legislation as a whole.[114]

A different and potentially difficult justification has been suggested concerning *implied* actions; namely, that these are a construct of provincial law; provincial common law rules concerning the implication of actions.[115] The former analysis is the simpler and more comprehensive, especially if implied actions are thought to derive from the dictates of public policy. I conclude that there is no constitutional impediment.

It is, one supposes, possible that the government might desire to leave the matter of civil liability largely, if not entirely, to judicial implication, at least in the first instance. Would this be a

111 [1931] A.C. 310 (P.C.); on the topic in general *see* Leigh, *The Criminal Law Power: A Study in Functional Concurrency*, 5 Alta. L. Rev. 237 (1967).

112 Alexander, *The Fate of Sterling Trusts v. Postma*, 2 Ottawa L. Rev. 441 (1968); and *see*, Transport Oil Ltd. v. Imperial Oil Ltd., [1935] O.R. 215 (C.A.); *but see also* Gordon v. Imperial Tobacco Sales Co., [1939] 2 D.L.R. 27 (Ont. H.C.); Wasney v. Jurazsky, [1933] 1 D.L.R. 616 (Man. C.A.) (*per* Trueman, J.A.).

113 Vapor Canada Ltd. v. MacDonald, *supra* note 109.

114 Direct Lumber Ltd. v. Western Plywood Ltd., [1962] S.C.R. 646, 650 (*per* Judson, J.), Floyd v. Edmonton City Dairy Ltd., [1935] 1 D.L.R. 754 (Alta. S.C.); Philco v. Thermionics Ltd., [1940] S.C.R. 501, 504.

115 Placatka v. Thompson [1941] 2 D.L.R. 320, 324 (Alta. C.A.) (*per* Ford, J.A.).

feasible option? There is doubt concerning under what circumstances Canadian courts will imply civil causes of action.[116] The precedents are discouraging.[117]

The topic of implied civil actions has been extensively discussed in academic writing. Professor J.G. Fleming states that save in exceptional cases, the imputation of a presumed legislative intent to confer a private right of action is a fiction. He writes: [117a]

> "In reality, an intent to give or deny an action for damages to the person injured has more often than not been ascribed to the legislature as a result of presumptions or by reference to policy considerations rather than the meaning of the instrument."

The U.S. theory that the civil action is not a true creature of statute is, he contends, intellectually more acceptable. Professor G. Williams by contrast argues that the American approach gives too free a hand to the judges, thereby confusing judicial and legislative functions. It would, he argues, be anachronistic to leave the creation of new areas of law or new classes of private rights to the hazards of litigation.[118] This is a very English point of view, acceptable no doubt in a unitary system and especially one enjoying cabinet government, but conceivably less acceptable in a federal system where, for political reasons, legislative power is not always pushed to its furthest extent. It is, nonetheless, a viewpoint which could well commend itself to Canadian courts which are likely to prove rather conservative in such matters.

It is, however, desirable to indicate what seem to be the conclusions which flow from adherence to statutory interpretation as the key to implied liability, and, as well, to suggest that the stock criticisms of U.S. developments are directed towards consequent evils which frequently do not exist in the rather exaggerated forms which commentators assume.

No doubt reliance upon statutory interpretation acts as a sheet anchor to judicial discretion. Narrowly applied, it would imply that the notion of statutes conferring rights of action lies along the boundaries of common law duties. That is, a court would be most likely to buttress its view of the policy of a statute by reference to whether the statute extended an area already partially protected at common law. But if a court can buttress that area by its view of the policy of a statute or, rather, of what the public

116 *See* P. Anisman at 314-18.

117 Ames v. Investo-Plan Ltd., 35 D.L.R. (3d) 613 (B.C.C.A. 1973).

117a J. Fleming, The Law of Torts 122 (4th ed. 1971); *see*, for a strong judicial view, O'Connor v. S.P. Bray Ltd., 56 C.L.R. 464 (1936).

118 Williams, *The Effect of Penal Legislation in the Law of Tort*, 23 Mod. L. Rev. 233 (1960).

interest requires, why should it not do so by reference to public policy where the duty is new and statutory? One could still have limiting principles of construction.

Part of the answer may derive from the consideration that English and Commonwealth judges in general do not care for social experiments at large. Liability, if it is to be imposed, is likely to be imposed strictly in terms of the statute without the aid of a mitigating discretion, the existence of which the judiciary might, and probably would, deny. Thus, Williams writes:[119]

> "Where the defendant is not under a duty of care at common law, the passing of a penal statute should not automatically be held to place him under a civil duty. The compelling reason is that liability in tort may be far more onerous than the criminal penalty specified in the statute. For one thing, the damages in tort may greatly exceed the penalty thought appropriate by the legislature. Again, the damages in tort follow inexorably from a decision of liability, whereas a criminal court has power to reduce or remit the penalty according to the degree of the defendant's wrong-doing."

These are substantial considerations. They are, as will be seen, given weight by Canadian courts. They do not, however, militate against policy considerations as founding liability. One can argue that Parliament, in imposing a relatively low fine, did not intend wide liability to flow from a breach of statute. One could argue *per contra* that a small fine was imposed simply because consequent civil liability would be great. And, in any event, English courts in some areas do impose civil liability simply in order to give legislation adequate teeth. The use of the constructive trust concept under section 54 of the United Kingdom Companies Acts dealing with the provision by a company of financial assistance for the purchase of its own shares is an example.[120] But it is clear that, adventurous though some U.S. courts may be, they create actions not in contradiction of the broad policies which the statute serves, but in aid of them. They do respect limitations which militate against the recognition of civil causes of action.[121] In addition some judges are inclined to adopt intermediate positions, for example, suggesting liability for damages for intentional rather than negligent infractions of a statute, while recognizing that for the purposes of other relief, *e.g.*, injunctive relief, negligent viola-

119 *Id.* at 256; *see also* J. Fleming, *supra* note 117a, at 126.

120 Selangor United Rubber Estates v. Cradock (No. 3), [1968] 1 W.L.R. 1555 (Ch.).

121 *E.g.* National R.R. Passenger Corp. v. National Assoc. of R.R. Passengers, 414 U.S. 453 (1972); and *see* Comment, *supra* note 76.

tions should suffice.[122] It remains to be seen whether Canadian courts are apt to be more or less adventurous in imposing liability.

The criteria employed by U.S. courts in determining whether to imply a civil action have already been discussed.

A criterion universally invoked both in United States and Canada is whether the legislation is intended for the protection of a particular class of persons. This criterion is quite liberally invoked in Canada. Motor vehicle legislation often results in the implication of civil actions, both because it is seen as directed towards the protection of other road users and because such liability is akin to traditional liability in negligence for vehicles. Thus, in *Sterling Trusts Corp. v. Postma*,[123] Cartwright, J. held that the breach by the driver of a motor vehicle of a statutory provision which is designed for the protection of other users of the highway gives a right of action to a user of the highway who is injured as a direct result of that breach. The provision requiring red rear lights is of this character. The questions for the court are said to be whether the defendant committed a breach of the provision and whether such breach was an effective cause of the accident. Whether liability is absolute or can be defeated by showing that the condition occurred without negligence were questions reserved by Spence, J., but absolute liability seems to be suggested by the rest of the Court. This decision has of course been consistently followed by lower courts.[124] Similarly, in *Paulsen v. C.P.R.*[125] a majority of the Manitoba Court of Appeal found the fencing requirments of railway legislation to be intended both for the protection of people and to keep animals off the railway track. A similar characterization, in some cases perhaps surprisingly, appears in a number of cases involving breaches of muncipal regulations. A not unexpected instance was a failure by a contractor to observe the provisions of the Alberta Gas Installation Act in installing a domestic gas supply, as a result of which children of the family died and one parent became severely ill.[126] The object of the legislative provision was to provide as part of the scheme of the legislation the creation of rights enforceable by action for the benefit of individuals such as the Ostash family.

122 *See* SEC v. Texas Gulf Sulphur Co., 401 F. 2d 833 (1968) (*per* Friendly, J.). The comparative rigidity of English courts is discussed in J. Fleming, *supra* note 117a, at 131 but it must be remembered that the courts are operating in quite a different constitutional milieu on these questions too.

123 Sterling Trust Corp. v. Postma, [1965] S.C.R. 324.

124 *E.g.* Blakney v. Leblanc, 2 N.B.R. (2d) 274 (C.A. 1970); Schofield v. Town of Oakville, [1968] 2 O.R. 409 (C.A.) (failure of a municipality to perform its statutory duty to repair a bridge).

125 43 W.W.R. 513 (Man. C.A. 1963).

126 Ostash v. Sonnenberg, 67 D.L.R. (2d) 311, 324 (Alta. C.A. 1968) (*per* Smith, C.J.).

Under certain legislation, for example, municipal zoning by-laws, the courts hold that the legislation renders a particular course of conduct imperative and a deviation from it punishable by penalty in the general interest of the public at large. In such cases, *prima facie*, an action for damages by a person injured by failure to perform the duty imposed does not lie.[127] The court in such cases is inclined to conclude that the remedies provided by the statute are intended to be the sole remedies available by way of guarantees to the public for the observance of the statutory duty, or by way of compensation to individuals who have suffered by reason of the nonperformance of that duty.[128] Inadequacy of the general penalty provided will not found the action.

Ordinarily, one would have little difficulty in concluding that much securities legislation came within the class described in the preceding paragraphs. One's doubts concern whether the fact that a single breach of the statute could engender multiple litigation almost limitless in extent is to be taken as a factor militating against private actions. The question arises as a result of *Direct Lumber Co. Ltd. v. Western Plywood Co. Ltd.*[129] in which Judson, J. in the Supreme Court expressly upheld the reasoning on this point of Johnson, J.A. in the court below. The case involved discriminatory trade practices, including the giving of discriminatory discounts, which were made criminal offences. Johnson, J.A. held that the matter depends on imputed legislative intent, that such intent will generally be found in cases involving industrial legislation and that the fact that a person is one whom the legislature intended to protect is not necessarily a determining factor in deciding whether or not a cause of action was intended. This emphasis certainly seems to contradict *Sterling Trusts Ltd. v. Postma*. On the issue of the scale of consequent litigation, a matter not dealt with in *Postma* at all, Johnson, J.A. states:[130]

> "In the case of a large concern doing business all across Canada which in violation of s. 412 gave a discount to one customer, it would follow that the company would be liable to all its customers who purchased at the higher price. It might be that such purchasers before as well as after the offence could sue. It is difficult to think that Parliament intended such consequences in addition to the penalty that the *Code* provides. It is more reasonable to assume that Parliament was intending to punish it by

127 Tompkins v. The Brockville Rink Co., 31 O.R. 124 (H.C. 1899).
128 Orpen v. Roberts, [1925] S.C.R. 364, 370 (*per* Duff, J.).
129 [1962] S.C.R. 646, *aff'g in part*, 32 D.L.R. (2d) 227 (Alta. C.A. 1962).
130 32 D.L.R. (2d) at 235.

making it a criminal offence to engage in unfair and restrictive trade practices and nothing more."

This concern about the extent of ultimate litigation appears in the municipal by-law cases as a factor against liability. It is not clear what weight courts will give to it; whether to accord it decisive significance or not. Hence the issue remains doubtful. Furthermore, there may well be difficulties of causation in some of these cases.

It should however be stressed that some implied liability does not involve this sort of problem. Where the vice alleged is a failure to observe statutory requirements in the operation of customers' accounts, multiple litigation would flow not from a single breach, but from a number of individual breaches. This sort of problem is, therefore, distinguishable. No one has ever doubted the wisdom of express statutory actions founded on misleading prospectuses, even though the eventual liability may be great. Not all civil actions for breach of a requirement such as that contained in Rule 10b-5 necessarily pose the problems to which Johnson, J.A. refers, and such rules are expressly designed for the protection of the public. But in some respects, where these dangers arise as where negligent press releases are concerned, U.S. courts are prepared to limit liability by reference to the culpability involved. The basic consideration is really economic; it cannot, as we have noted, seem logical from the point of view of the individual investor to allow liability where the loss arose from the defendant's intentional act or omission, but not where it derives from negligence. Would a Canadian court be flexible in this fashion or would it adopt an holistic approach, tending towards disallowing actions where application of the provisions would result in almost unlimited recovery; for example where the essence of the defendant's conduct lay in poisoning the market?

I conclude that the uncertainties concerning whether civil actions will be implied are such that it would be unwise to rely simply on the common law rules if it is desired to employ civil actions in aid. We cannot predict what attitude courts will adopt, nor is it altogether fair to ask them to solve basic policy problems which we have not faced. Hence I advocate a provision like that of section 1417 of the *ALI Federal Securities Code*, and I do not think that it would be wise to rely on common law implication.

15. *Rights of Action and Damages*

One of the principal fears associated with the creation of causes of action outside the privity situation is the very large amount of damages which may ultimately be awarded against the

defendant. These fears are exacerbated where, as in the United States, fairly liberal rules concerning class actions apply. The purposes of civil actions, especially where the cause of action relates to market manipulation, to the dissemination of false information which has an effect on dealings, and insider trading, are both compensatory and deterrent. In effect, the civil action is often employed as an adjunct to agency enforcement. Hence the consequence traditionally feared, the award of large damages, is the consequence which seems from a deterrent point of view most agreeable to the agency.

The consequence of liability in any case must, if traditional damages principles are employed, be computable strictly arithmetically. Unlike a criminal penalty which can be tailored to the circumstances of the accused, the quantum of damages cannot. There is therefore a risk of severe economic dislocation from the award of damages, at any rate where they are awarded against a large enterprise. Unless this difficulty can be overcome, there are bound to be doubts about the wisdom of extending civil actions into the areas above mentioned.

The alternatives appear to be these:

(1) not to create rights of action outside the privity situation; in effect to adopt provisions like those proposed for Ontario in Bill 30;

(2) to create wide rights of action but to limit the extent to which these can be vindicated by class actions. Such a limitation would enable persons who had suffered large damages to sue; it would however probably limit severely the occasions upon which such actions would be brought. But it would in theory permit recovery of substantial losses;

(3) to create wide rights of action with class actions in aid but to impose arbitrary upper limits to recovery. This enables the risk of economic dislocation to be minimized, but in theory may mean that a plaintiff whose loss is substantial gets much less recompense than he ought to receive according to accepted principles of private law;

(4) to create wide rights of action with class actions in aid, and without any limits whatsoever. This entails running the risk of large awards.

Which alternative is to be chosen depends upon the extent to which one wishes to stress the public aspects of the damage action; that is, its potential as a measure of deterrence. The U.S. experience indicates that agency enforcement is simply not sufficient to enforce the due observance of the securities laws. While therefore my personal preference would be to leave matters such as dealings in the markets where there has been a violation of requirements to

file documents such as distribution statements (*ALI Federal Securities Code*, sections 1401 and 509), or insider trading where persons have dealt generally in the market or trading where there has been manipulation of the market to criminal and administrative proceedings, I recognize that it may be unwise to do this from an enforcement point of view. Insider trading in particular may need to be redressed by a very wide action. Actions founded on false publicity may also need to be enforced by wide actions. I would therefore not adopt the Ontario solution, but I would submit that extensive civil actions should be restricted to areas where the problems are great and the U.S. experience at least suggests that civil actions are necessary as a deterrent measure; insider trading, false publicity, but not manipulation in general.

The dangers of pyrrhic awards are sufficiently great to convince one that alternative (4) should not be adopted. The choice is between the second and third alternatives. The second at least permits persons who have sustained large losses and who wish to sue to do so. It is however likely that few people will suffer sufficiently large losses individually to contemplate bringing complicated and protracted civil proceedings. If we are to stress deterrence, the third alternative, provided suitable limitations to damages can be found, seems appropriate. One must however recognize that without a contingency fee system and a tolerance of entrepreneurial attitudes by the bar, civil actions are unlikely to be weapons as frequently invoked as they are in the United States. We are likely to have to rely throughout on the commission as the primary source of enforcement whatever the text of the law.

The *ALI Federal Securities Code* endeavours to deal with the problem. Certain of the sections impose upper limits to damage awards. Section 1402(b) dealing with insider trading in the markets limits damages by providing that the measure specified is reduced to the extent that the defendant proves that the violation did not cause the loss (in effect a no causation defence) and limited also by the amount of securities that the *defendant* sold or bought. The actions in section 1403 concerning false registration statements, and section 1408 dealing with manipulation is subject to an upper limit of the greatest of $100,000 or 1% to a maximum of $1,000,000 of gross revenues in the defendant's last fiscal year before filing the action, and his profit on any sale of a security of the class before the facts constituting the violation became generally known.

Section 1409 of the *ALI Code* provides machinery for the prorationing of damages. The defendant notifies the court if there are multiple claims against him. These may then be stayed and consolidated. If the aggregate award of damages exceeds the

upper limits imposed by the sections creating the causes of action, these may then be awarded pro rata among plaintiffs in accordance with their claims.

The difficulty with this machinery is simply that a plaintiff who suffers large losses may be baulked of his recovery by machinery which enures to the benefit of claimants, some quite small, who may be before the court by reason only of extensive class action procedures. On the other hand there are, I submit, few cases in which this result is likely to occur. U.S. experience would suggest that effective civil actions are a necessary measure of deterrence.

16. *Class Actions*

It is not enough simply to create extensive damage actions. Means must be found to make these actions effective. Where losses, though large in the aggregate, are small individually, the machinery is apt to be underutilized. In practical terms, means must be found to aggregate claims and to make the pursuit of actions rewarding for litigants and, above all, for their lawyers. In the alternative the state could be empowered to bring proceedings. A further possibility is to facilitate both private actions and actions by the state.

A striking aspect of recent American development has been the development of the class action, which at times appeared almost cut off from its roots in private redress. It attained real significance as a regulatory device in the public interest. The first device with which this section deals is the class action. Consolidation procedures, etc., are well known. The impact of the class action and its shortcomings are of crucial significance, certainly in the enforcement of U.S. securities legislation and, as well, in the structure of the American Law Institute proposals. As one note states:[131]

> "The substantive law and procedure interact in many subtle ways in other areas of the law, but in the case of class actions brought under the Truth in Lending Act the union of substance and procedure has given birth to the prospect of damages which might financially cripple or destroy major credit institutions."

The potential impact of the class action on securities regulation is scarcely less profound.[132]

I propose to outline the United States Class Action Rule; to

131 Note, *Class Actions Under the Truth in Lending Act*, 83 YALE L.J. 1401 (1974).

132 *See e.g.* Kahan v. Rosenstiel, 424 F.2d 291 (3d Cir. 1970); Green v. Wolf Corp., 406 F.2d

discuss some of the hopes expressed for it, recent litigation which has curtailed these hopes, the difficulties which surround its use, and then to evaluate what use we might make of the device or any available alternatives.

The United States rule is discussed here, first, because it is the most highly developed rule that I have encountered and second, because it has been the subject of much creative judicial use and academic comment. Its Canadian and Commonwealth counterparts are, so far as I have been able to determine, primitive by comparison.[133] The basic scheme of the rule is followed in the proposed Uniform Class Actions Rule adopted by the National Conference of Commissioners on Uniform State Laws in 1976. Rule 23 provides in part:[134]

> "(a) *Prerequisites to a Class Action.* One or more members of a class may sue or be sued as representative parties on behalf of all only if (1) the class is so numerous that joinder of all members is impracticable, (2) there are questions of law or fact common to the class, (3) the claims or defences of the representative parties are typical of the claims or defences of the class, and (4) the representative parties will fairly and adequately protect the interests of the class.
>
> "(b) *Class Actions Maintainable.* An action may be maintained as a class action if the prerequisites of subdivision (a) are satisfied; and in addition:
>
> "(1) the prosecution of separate actions by or against individual members of the class would create a risk of
>
> "(A) inconsistent or varying adjudications with respect to individual members of the class which would establish incompatible standards of conduct for the party opposing the class, or
>
> "(B) adjudications with respect to individual members of the class which would as a practical matter be dispositive of the interests of the other members not parties to the adjudications, or substantially impair or impede their ability to protect their interests; or
>
> "(2) the party opposing the class has acted or refused on grounds generally applicable to the class, thereby mak-

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291 (2d Cir. 1968); Note, *The Impact of Class Actions on Rule 10b-5*, 38 U. Chi. L. Rev. 337 (1971).

133 For a Canadian source, *see* Panel, *Class Actions and Related Matters*, in Canadian Bar Association (Alberta Branch), Selected Proceedings 133 (P. Ketchum, Chairman 1973); *see also* N. Williams, Consumer Class Actions (1974).

134 Fed. R. Civ. P. 23 (1966).

ing appropriate final injunctive relief or corresponding declaratory relief with respect to the class as a whole; or "(3) the court finds that the questions of law or fact common to the members of the class predominate over any questions affecting only individual members, and that a class action is superior to other available methods for the fair and efficient adjudication of the controversy. The matters pertinent to the findings include: (A) the interest of members of the class in individually controlling the prosecution or defence of separate actions; (B) the extent and nature of any litigation concerning the controversy already commenced by or against members of the class; (C) the desirability or undesirability of concentrating the litigation of the claims as the particular forum; (D) the difficulties likely to be encountered in the management of a class action."

Further provisions of the rule provide for a determination by the court, conditional or final, whether the action is to be maintained as a class action. The court is to direct to the members of the class the best notice practicable under the circumstances including individual notice to all members who can be identified through reasonable effort. The following extract from subsection (c)(2) indicates the crucial significance of the notice provision:

"The notice shall advise each member that (A) the court will exclude them from the class if he so requests by a specified date; (B) the judgment, whether favourable or not, will include all members who do not request exclusion; and (C) any member who does not request exclusion may, if he desires, enter an appearance through his counsel."

This reflects an "opting-out" requirement. Members who do not "opt out" of a class action will be bound by the judgment. This is so even though they may have remained entirely passive towards the action.

The rule further provides that where appropriate an action may be brought or maintained as a class action with respect to particular issues. A class may be divided into subclasses and each subclass treated as a class. The provisions of the rule are then to be construed and applied accordingly. Rule 23 has given an impetus to class actions.

Rule 23(b)(3) which applies to class actions for damages has undoubtedly proved to be controversial. On one hand it is thought that the class action is the only means of redressing infractions of, *inter alia*, securities legislation. On the other it is argued that the economic devastation that would follow upon an enormous recov-

ery indicates the folly of allowing huge actions to be brought in respect of claimants who would never have sued for their own small claims. In addition, it is argued that the class action lends itself with some frequency to blackmailing settlements.[135] Furthermore, it has been argued that if the thrust of the class action is deterrence, the appropriate response is to increase the applicable criminal penalty and not to rely on the class action, or to abandon the class action in favour of a governmental action.[136]

There seem to be several distinct problems. In particular, should the class action be viewed primarily as an instrument of public redress or should it sound primarily in private redress? There is in any event no absolute exclusivity here since an action seen as essentially for the benefit of private litigants may well serve an important public purpose as well. If the former is the desired result, what can the U.S. experience with class actions under Rule 23 teach us? Should we perhaps, in the light of that experience, seek another mode of public redress, leaving the class action as a useful but not revolutionary procedure in aid of private right? If the class action is to sound in private redress, is Rule 23, as interpreted, a suitable drafting model, or should amendments be made to it, or should it be disregarded altogether?

What has happened to class actions under Rule 23 throws, I think, some light on the first question. It may be true, as a recent U.S. Senate report suggests, that most class actions involve classes sufficiently small to render the actions manageable and to make individual notice to class members possible.[137] There have been some striking exceptions to that generalization. The courts were and are broadly sympathetic to the proposition that class actions are a necessary vehicle for the vindication of small federal claims.[138] The advent of very large class actions, however, posed problems both practical and doctrinal.

The idea of the class action essentially as an instrument of public redress was rapidly perceived and exploited by the legal profession. After 1966 when the present Rule 23 was introduced, class actions proliferated. The courts, faced with the necessity of interpreting the rule according to its terms, set something of a

135 Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

136 Staff of U.S. Senate Commerce Committee, 93d Cong., 2d Sess., Class Action Study (1974).

137 *Id.*

138 *See e.g.* Berland v. Mack, 48 F.R.D. 121 (S.D.N.Y. 1969); Kahan v. Rosenstiel, 424 F.2d 161 (3d Cir. 1970); Zahn v. Int'l Paper Co., 414 U.S. 291 (1973); Green v. Wolf Corp., 406 F.2d 291 (2d Cir. 1968); and *see* Escott v. BarChris Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968); Note, *supra* note 132.

brake on such developments. In class actions, Rosenfeld remarks, the important factor[139]

> "[I]s that wrongdoers should be forced to return their illegally obtained profits and not that individual class members have a right to repayment."

From this premise, the inhibitions contained in Rule 23 indeed look irksome. The solution is either to treat these as mere technicalities, to be overborne by large and sympathetic interpretations, or, as the U.S. Senate committee recommends, to devise new machinery.[140]

The difficult procedural problems have centred around the requirements of manageability, notice, costs and standing. The question of whether the would-be class is sufficiently united in interest is less often troublesome.[141] Thus courts have held that where a common scheme of deception has been alleged, a common question exists even if the suit is based on otherwise unrelated nondisclosures or misrepresentations.[142] In an action complaining of the withholding of relevant information the existence of individual issues of reliance does not hinder the predominance of the common question; the actionability of the defendant's conduct.[143] Apart from those matters which derive from the wording of Rule 23 itself, the class action really requires that materiality be taken as proving a *prima facie* case of reliance. The rule in *Affiliated Ute* is not of course restricted to the class action, but it is necessary to make it effective. Proof of reliance also poses problems, essentially seen as aspects of manageability, on the distribution of any recovery including the matter of disposing of any unclaimed balance after notice of recovery to the class. It is in this

139 Rosenfeld, *The Impact of Class Actions on Corporate and Securities Law*, [1972] Duke L.J. 1167.

140 Staff of U.S. Senate Commerce Committee, *supra* note 136; and *see*, *Vanik Introduces Bills Aimed at Overcoming Restraints to Class Action Suits Posed by Eisen, Zahn Decisions*, 268 BNA Sec. Reg. & L. Rep., September 11, 1974, at A-18.

141 *See*, however, Winokur v. Bell, 58 F.R.D. 178, 41 U.S.L.W. 2259 (N.D. Ill. 1972) insisting on common representations under Rule 10b-5; La Mar v. H.B. Novelty & Loan Co., 489 F.2d 461 (9th Cir. 1973); and *see* the very permissive judgment allowing want of standing in the original class to be cured by the joinder of persons having standing, Haas v. Pittsburgh Nat'l Bank, 60 F.R.D. 604 (W.D. Pa. 1972); Re U.S. Financial Securities Litigation, [1977-1978 Transfer Binder] CCH Fed Sec. L. Rep. ¶ 96,838 (S.D. Cal. 1974) (where different documents are relied on as the source of a misrepresentation, the misrepresentations must be the same or similar, or that the misrepresentations were part of a single manipulative scheme); *see also* Miller v. Central Chinchilla Group Inc., [1974-1975 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 95,077 (S.D. Iowa 1975) (class actions are inappropriate in the case of oral misrepresentations).

142 Simon v. Westinghouse Electric Corp., [1977-1978 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 96,094 (E.D. Pa. 1977).

143 Cameron v. E.M. Adams & Co., 547 F.2d 473 (9th Cir. 1977); Sargent v. Genesco, 75 F.R.D. 79 (M.D. Fla. 1977).

latter respect that advocates of the class action clearly desired it to move away from its traditional roots. Finally, and perhaps inevitably, it was alleged that the class action was being used as a means of coercing settlements.

Some courts are tolerant of manageability, even where large administrative tasks are involved. Class actions should not, it is said, be defeated because the defendant has taken so much from so many that the resulting actions become very complicated.[144] But the courts have also stated that Rule 23 is not intended to permit redress for all wrongs without limitations. Where, therefore, problems of notice and of the distribution of any recovery arose, courts invoked the notice and manageability bars to the rule. Actions on behalf of six million purchasers of gasoline at retail,[145] and all consumers of eggs in the United States,[146] were disallowed on these grounds. Other courts were willing to allow the action to proceed with a view to devising machinery for the allocation of recoveries at a later stage.[147] Plaintiffs' attorneys responded on two levels.[148] The first was to argue that the individual notice requirement was technical and should not therefore be so interpreted as to block meritorious litigation. The crux, according to this argument, is that if class actions are barred because the class is thought to be unmanageably large, the wrongdoer is enabled to benefit from his own wrong. The second response was the imaginative invention of the "fluid class" notion in order to solve the problem of distribution of recovery, a device necessitated by the fact that the membership of large classes is apt to change between the date of the wrong and the date of judgment. Persons were invited to submit claims against the judgment fund. Any residue would be applied *cy pres* by the court. In a drug antitrust case the monies were disbursed to state health care programmes. In *Eisen v. Carlisle and Jacquelin*[149] it was suggested by counsel that the recovery in an odd-lot differential case be applied by the wrongdoers on reducing the odd-lot differential in future. The result, Rosenfeld states, would be:[150]

> "Thus, the wrongdoers would surrender their illegal profits, and the defence of unmanageability would be by-passed. As a result the *class* of odd-lot buyers and

144 Appelton Electric Co. v. Advance-United Expressways, 494 F.2d 126 (7th Cir. 1974).
145 City of Philadelphia v. American Oil Co., 53 F.R.D. 45 (D.N.J. 1971).
146 United Egg Producers v. Bauer International Corp., 312 F. Supp. 319 (S.D.N.Y. 1970).
147 *In re* Co-ordinated Practical Proceedings in Antibiotic Anti-trust Actions, 333 F. Supp. 267 (S.D.N.Y. 1971).
148 Rosenfeld, *supra* note 139.
149 94 S. Ct. 2140 (1974).
150 Rosenfeld, *supra* note 139; and *see* Note, *supra* note 132.

> sellers would be made whole, although each of the individuals who overpaid because of the fixed price would not necessarily be compensated."

The emphasis quite clearly is on policing the market and sustaining standards generally, rather than on individual recovery. This impression is reinforced by the statement that:[151]

> "Attempting to ascertain and pay each class member his exact damages may not only be too burdensome for the court, but may also be an expense that would consume too great a portion of the recovery."

The suggestion was imaginative, but it was not warranted by the wording of Rule 23.

The device of a preliminary enquiry on the merits was also suggested as an answer to problems of manageability and costs.[152] Some courts were prepared to proceed thus; others insisted that the sole question before the court is whether the requirements of Rule 23 were met.[153] In a doubtful case, the action should be allowed to go forward as a class action.[154] Preliminary hearings were in some quarters thought to confer illusory advantages only, since in only rare cases could the court assume that the class would ultimately succeed. Nonetheless the defendant could be required to share some of the costs if the claim appeared meritorious.[155]

The impact of the class action also affected the elements of the action itself. This is particularly noticeable in relation to issues of reliance and causation. In *T.S.C. Industries Inc. v. Northway Inc.*[156] the Supreme Court holds that the test of materiality is whether the reasonable man would have attached importance to the fact misrepresented. The decision apparently alters the concept of materiality enunciated earlier in *Mills v. Electric Auto-Lite Co.* where the test is said to be whether the defect was of such a character that it might have been considered important, in that case to a reasonable shareholder who was deciding how to vote (in the light of a proxy statement).[157]

In 10b-5 actions the position is more confused. It is sometimes thought that *Affiliated Ute Citizens of Utah v. United States*[158] is an

151 Rosenfeld, *supra* note 139, at 1182.
152 Dolgow v. Anderson, 53 F.R.D. 664, 40 U.S.L.W. 2236 (E.D.N.Y. 1971); Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970).
153 Miller v. Mackey Int'l Inc., 452 F.2d 424 (5th Cir. 1971); Katz v. Carte Blanche Corp., 52 F.R.D. 510 (W.D. Pa. 1971).
154 Kahan v. Rosenstiel, 424 F.2d 161 (3d Cir. 1970).
155 Berland v. Mack, *supra* note 138.
156 96 S. Ct. 2126 (1976).
157 396 U.S. 375 (1970); *see further* Lowenfels, *supra* note 75; PLI, *supra* note 84.
158 92 S. Ct. 1456 (1972).

authority against there ever being an obligation on the part of the plaintiff to prove reliance in class actions.[159] This may overstate the effect of the case which seems to turn on nondisclosure by persons who placed themselves in a near fiduciary relationship to the plaintiffs.[160] Reliance must be shown in some individual suits.[161] Difficulties as we have seen arise concerning the extent to which materiality can be invoked in order to raise a *prima facie* presumption of reliance and causation.[162] Some courts and writers assume that it is proper for a court to deal with issues of reliance by deferring them to a later stage, but that reliance must at some point be proven.[163] Other courts conclude that at any rate, where the action depends upon an omission, a withholding of relevant information, the plaintiff need not prove reliance but only materiality.[164] Whether reliance will be required in the United States after *Blue Chip Stamps v. Manor Drug Stores*[165] in cases of affirmative misrepresentation is not clear.[166] What does seem to be clear is that to have different rules depending upon whether the matter is characterized as misrepresentation by omission or by positive misstatement is quite illogical. The *ALI Federal Securities Code* is inclined to solve the problem by reversing the onus of proof, giving a defendant a defence to the extent that he or it can prove nonreliance by the plaintiff or plaintiffs. This is likely to bear as hard on defendants as the contrary rule would bear on plaintiffs but it is, I submit, a practical necessity. Arguably, the ALI proposal is no more than a straightforward interpretation of *Affiliated Ute* and is certainly more workable than requiring proof of reliance in the first instance or in some cases at all.[167]

While U.S. courts evince no hostility towards class actions as such, some of the more adventurous constructions of Rule 23 have been struck down by the courts. Thus, a diversity suit seeking damages cannot be maintained as a class action under Rule

159 Dorfman v. First Boston Corp., 336 F. Supp. 1089 (E.D.P.A. 1972).

160 *See further* Ruder & Cross, *Limitations on Civil Liability Under Rule 10b-5*, [1972] Duke L.J. 1125.

161 List v. Fashion Park Inc., 340 F.2d 457 (2d Cir. 1965), *cert. denied*, 382 U.S. 811 (1965).

162 Chris-Craft Indus. v. Piper Aircraft Corp., 480 F.2d 341 (2d Cir. 1972), *cert. denied*, 414 U.S. 910 (1973); Shapiro v. Merrill Lynch, Pierce, Fenner & Smith Inc., *supra* note 87.

163 Ruder & Cross, *supra* note 160; Berland v. Mack, *supra* note 138; Green v. Wolf Corp., *supra* note 132; and *see* Note, *supra* note 132; Tucker v. Arthur Anderson & Co., 67 F.R.D. 468 (S.D.N.Y. 1975); Felderman v. Empire Fire and Marine Ins. Co., [1974-1975 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,822 (S.D.N.Y. 1974).

164 Cameron v. E.M. Adams & Co., [1976-1977 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 95,819 (9th Cir. 1977).

165 421 U.S. 723 (1975).

166 PLI, *supra* note 84.

167 *See further*, Blackie v. Barrack, 524 F.2d 891 (9th Cir. 1975).

23(b)(3) in the absence of a showing that each of the unnamed members of the class independently satisfies the jurisdictional amount requirements of the legislation even though each of the named plaintiffs met jurisdictional amount requirements.[168] This particular difficulty does not arise under the securities laws because jurisdiction is not founded on diversity.

More significant is the decision of the Supreme Court in *Eisen v. Carlisle & Jacquelin* upholding the notice requirement of Rule 23 and striking down the fluid class concept.[169] The case deals with alleged antitrust violations in connection with the purchase and sale of odd lots on the New York Stock Exchange in May and June 1966. The plaintiff's own loss was put at an estimated $70. The class, it ultimately transpired, consists of six million people of whom 2,250,000 could be easily identified. Members of the class resided in every state of the United States and in some foreign countries. The estimated total damages were $120 million. The plaintiff could not afford the expense of giving notice to all members of the class. The lower court directed the plaintiff to give actual notice to selected groupings of persons within the class, *e.g.*, to 2,000 or more class members who had ten or more transactions during the relevant period and 5,000 other class members selected at random from the 2,250,000 members who could be readily identified. On the question of who was initially to bear the costs, the lower court directed a brief preliminary hearing on the merits and then concluded that the defendants must bear 90% of all expenses. As many of the six million persons would never claim against the recovery, the balance was to be used for the benefit of all odd-lot traders by reducing the odd-lot differential in an amount determined by the court to be reasonable until the fund was depleted. This disposition was disapproved by the Court of Appeals and the Supreme Court.

The Supreme Court, addressing itself to the requirements of Rule 23, notes that under its terms the court must direct to class members the best notice practicable under the circumstances including individual notice to all members who can be identified through reasonable effort. Individual notice *must* therefore be sent to all class members whose names and addresses may be ascertained through reasonable effort. Arguments about the policy of class suits, or whether it is necessary to have individual notice in cases where individual recovery is so small that it is unlikely that individuals would sue, are irrelevant. The requirement of individual notice is not discretionary, but mandatory. The idea behind

168 Zahn v. Int'l Paper Co., 414 U.S. 291 (1973).
169 94 S. Ct. 2140 (1973), *aff'g*, 479 F.2d 1005 (2d Cir. 1970).

Rule 23 is to bind all class members who did not request exclusion from the suit. Justice Powell thus states:[170]

> "Accordingly, each class member who can be identified through reasonable effort must be notified that he may request exclusion from the action and thereby preserve his opportunity to press his claim separately or that he may remain in the class and perhaps participate in the management of the action. There is nothing in Rule 23 to suggest that the notice requirements can be tailored to fit the pocket books of particular plaintiffs."

The plaintiff must bear the costs of notice. The use of a preliminary hearing on the merits as an allocation device was rejected. It is unauthorized by the rule; it would allow a representative plaintiff to secure the benefits of a class action without first satisfying the requirements for it in that he could obtain a determination on the merits of the claims advanced on behalf of the class without any assurance that a class action could be maintained. The defendant could as a result suffer prejudice. The result is consistent with the general U.S. rule that when the parties are truly adversary the plaintiff must pay the costs of notice as part of the ordinary burden of financing his own suit. Justices Douglas, Brennan and Marshall, dissenting in part, would have remitted the action to see whether subclasses could be created, in whose name the action could proceed.

The Court of Appeals for the Second Circuit had also dealt with the "fluid recovery" procedure in cases where individual claims are of little consequence.[171] This part of the decision was not dealt with by the Supreme Court. The Court of Appeals concludes that the fluid recovery procedure is not authorized by Rule 23, is inadmissible as a solution to the manageability problems of class actions and wholly improper. The *in terrorem* effects of the innovations amount, it was alleged, to legalized blackmail, producing settlements in cases where the merits of the claim are doubtful. It is improbable that the Supreme Court would take a different view of the matter.[172]

Nonetheless, the Court of Appeals recognizes that real problems are posed by wrongs which give rise to large numbers of losses, few of which are large enough to render practicable individual actions for redress. There is a need for an adequate remedy.

170 94 S. Ct. at 2152 (*per* Powell, J.).
171 479 F.2d 1005 (2d Cir. 1973).
172 Blue Chip Stamps v. Manor Drug Stores Inc., *supra* note 135.

Rule 23 works well in cases where the class is not unduly large. But, as the Court states:[173]

> "It seems doubtful that further amendments to Rule 23 can be expected to be effective where there are millions of members of the class, without some infringement of constitutional requirements."

The Court therefore invites Congress to consider creating an agency to vindicate consumer rights. It draws attention to the injunction as a remedy more desirable than class actions for damages. It seems clear that the court, and indeed other courts as well, are troubled by blackmail settlements which are felt to benefit plaintiffs' attorneys primarily. The prospect of ruinous judments is also uncongenial.[174]

The United States Senate Commerce Committee has recently advocated new legislation to enable large classes of plaintiffs to recover small individual claims. It suggests that new class action legislation might prevent unjust enrichment of the defendant even when significant individual recovery among consumer class members is not possible. Rule 23, the committee notes, is designed to protect the interests of individual class members. It hinders class actions on behalf of large numbers of consumers with meritorious claims too small to support individual suits, thus frustrating other valid ends of consumer class actions such as the prevention of unjust enrichment and deterrence. The Committee advocates the use of the "fluid recovery" device and the *cy pres* doctrine in aid.

I propose to rehearse some of the committee's findings before evaluating proposals for reform. The principal sample employed by the committee was of cases in the District of Columbia. In addition, the committee considered a small sample from the country at large. The chief points appear to be:

(1) There has been a substantial increase in class actions since Rule 23 came into effect in 1966.
(2) The majority of class actions do not seek monetary relief.
(3) While some classes are very large, only 14% of actions had classes with more than 100,000 members; 25% had classes under 10,000 members.[175]
(4) Few defendants settle. Some 55% of cases were disposed of in favour of the defendant on a preliminary motion, the largest single bloc of which was for failure to state a claim. Few cases are frivolous. A very small proportion of cases went to trial,

173 479 F.2d at 1019; this latter phrase reflects the "Case and Controversy" clause of the United States Constitution.

174 *See* Blue Chip Stamps v. Manor Drug Stores, *supra* note 135.

175 It seems fair to conclude that classes in Canada would be much smaller.

but in the District of Columbia only 5% *of all* civil cases terminated were tried on the merits.

(5) Class actions in general do not take markedly longer from filing to disposition in the District Court than do civil actions in general. If, however, actions were not disposed of early in the litigation, problems concerning certification, notice and damage distribution did sometimes arise.

(6) Courts often considered the merits of class actions along with and in aid of a decision on the certification issue. Plaintiffs felt it essential to present a strong case on the merits as well as on the class issues before the certification issue arose, since they felt it unlikely that certification would be granted in a case in which the judge was not convinced that the plaintiff had a meritorious claim. (It will be interesting to see whether this will survive *Eisen*.)

(7) In general, individual notice was given to defendants. Classes were often small and manageable. In some cases it was difficult to show that all potential members were indeed notified. Some notices were for example returned because the addresses returned were inaccurate. Other forms of notice had then to be resorted to. The costs of other forms of notice were often no less expensive than the costs of giving individual notice.

(8) The costs of notice were not unduly high, except perhaps in very large actions. In no case did costs of notice exceed 5% of total recovery.

(9) Information concerning distribution of damages is limited, but the sample does show that problems of manageability and administrative costs were not overwhelming in most cases. In no instances were the problems of damage distribution insurmountable or class awards consumed by costs. Class size did however diminish substantially between the time of certification and the time of allocation of damages. Unclaimed amounts were sometimes left over. In some cases "fluid recovery" was used, in other cases the surplus was returned.

(10) Few individuals use the opt-out procedure under Rule 23. It does not, therefore, contribute substantially to the reduction of class sizes.

(11) It was suggested to the committee that attorneys frequently abused the class action by engaging in solicitation to create a class and by using it primarily as a vehicle to collect exorbitant fees. The committee doubted whether this was so. Few defendants' lawyers thought that class actions were being brought frivolously. It was thought that attorneys were unlikely to devote the amount of time and effort required in such actions unless the action seemed meritorious.

(12) The contingency fee is distrusted. It is thought to facilitate the recovery by attorneys of enormous fees. There was felt to be need for a system that prevents unreasonable awards, yet provides sufficient incentive for attorneys to bring meritorious suits. Only partial provision is made for this at present. The court must, under Rule 23, scrutinize attorneys' fees where a claim is being compromised or settled.

The study reaches some interesting conclusions. It considers that Rule 23 procedure is effective in the case of small classes but that, viewed from the standpoint of individual compensation, large classes with small individual claims are particularly apt to be unmanageable. Procedures ought however to be changed to give primacy to such other goals as deterrence and the prevention of unjust enrichment. Machinery should be devised to allow cases to proceed even though, because of problems of class size and manageability, the action could not proceed as under Rule 23. Flexibility is needed in dividing classes and subclasses, and in devising notification procedures. If compensation to individuals is not feasible, machinery should be devised for the exaction of a deterrent fund from the defendant. Such machinery is of course suggested in section 1409 of the *ALI Federal Securities Code*, discussed above. The study considers distribution *cy pres*, with the damage fund held open for long enough to allow claims against it. Even within the context of Rule 23, the opting-out device should be perpetuated.

There are two matters upon which further information is desirable. Are the figures for large class actions too low? Experience under the Truth in Lending Act suggests that this may be so.[176] Has Rule 23 had the effect of reducing class sizes; that is, is it reponsible for the finding that few class actions involve astronomical numbers of plaintiffs? What direct and oblique results can one assume would follow from adoption of the Senate Study recommendations? It cannot be said that the study probed this aspect of the matter closely.

I conclude that:

(1) We should facilitate class actions in Canada and adopt a class action rule similar in terms to Rule 23.

(2) We should not however follow the U.S. Senate Commerce Committee's suggestion to facilitate the use of the class action as an instrument of depriving defendants of unjust enrichment. Deterrence can be provided for in the normal class action or by criminal, injunctive or other proceedings.

(3) We ought to explore as an adjunct to the class action the

176 Note, *supra* note 131.

notion of an action brought by a government agency to vindicate private rights.

It is, I trust, unnecessary further to stress the advantages of Rule 23 as a mechanism for enforcing private rights. It combines claims, with a consequent saving of judicial time. It enables persons having some elements of common interest to finance expensive litigation. It enables persons who do not want to come into the class to opt out if they so wish. By using an opting-out device persons basically ill-informed, or ignorant of the ways in which their rights can be vindicated may be joined in the action. At the same time, the action can only be certified where the class action is a manageable and practical device. I see no reason to doubt the U.S. Senate Commerce Committee's assertion that the rule works well except in cases of a large number of small claims which, individually, would probably not be litigated otherwise. In most cases it will probably not be unduly difficult to ascertain the boundaries of the proposed class.[177] Rosenfeld notes that in the United States, class actions have been used most frequently under the proxy and anti-fraud provisions of the Securities Exchange Act of 1934 and the registration provisions of the Securities Act of 1933.[178] The action based on proxies is the simplest variety because each member of the class is identifiable; the alleged wrong took place at the same time for all class members, and damage to each and every member of the class can be measured in the same manner. Thus, the two principal problems, identification of class members and individual reliance, may not be present in a proxy fraud case. Registration statement violations are dealt with under section 11 of the Securities Act of 1933 which imposes liability upon persons responsible for a registration statement if the registration statement or prospectus contains an untrue statement of material fact or omits to state a material fact or omits to state a material fact required to be stated therein, or necessary to make the statements therein not misleading. The liability thus created is nearly absolute. There is no need to show how the alleged omission affected the judgment of each class member. It is said that the class action device provides the only practical way in which those who are damaged by a false registration statement can be repaid. Liability is potentially more open-ended than in a proxy case.

Actions founded on a breach of section 10b-5 can give rise to vexed problems of scale. According to Rosenfeld, in a typical Rule

177 Thus, in Shapiro v. Merrill Lynch, Pierce, Fenner & Smith Inc., *supra* note 87, the class was readily determined as comprising all purchasers who traded contemporaneously with the defendant's wrongdoing.

178 Rosenfeld, *supra* note 139.

10b-5 class action, a company's publicly issued earnings report is challenged as false and misleading. If the company's stock drops in value, any person who bought the security after the earnings statement was published may bring a class action on behalf of all other persons who bought the security after the publication date. Liability is sometimes not observed for several years. The class in whose name the action is brought may be huge. The scale of the action is not, he asserts, the true problem. The real problem:[179]

> "...is not the fact that the class is often very large and, in turn, difficult to identify and locate, but rather the fact that the merits of some section 10(b) actions are sometimes thought to be thin."

As an example he cites the *Texas Gulf Sulphur* case where the press release was drafted under great time pressure by nonlawyers for nonlawyers.

There is I think, an element of truth in this assertion. But, apart from merits, we need to determine what the leading feature is to be, deterrence or whether a compensable loss has occurred.

Consistent with the approach taken earlier in this paper, I do not advocate the adoption of a more restrictive class action rule than that afforded by Rule 23b. I do advocate the imposition of an upper limit to damages as suggested by the *ALI Federal Securities Code*. We do, I submit, need civil actions in aid of deterrence and this involves having effective machinery. In my submission we should introduce class action machinery along the lines of Rule 23b, but in areas where giant recoveries are to be anticipated, the dangers should be limited by a limitation of damages provision of the sort contained in the *ALI Federal Securities Code*. The provisions of the rule such as manageability and notice should be strictly enforced.

I doubt whether enforcing manageability requirements would kill the class action. Most classes, according to the U.S. Senate Commerce Committee are small enough to be manageable, and indeed, the existence of Rule 23 may induce counsel to consider carefully what the class is to be, how closely it should be defined, etc. Classes seem still to be numerous enough to make recovery worthwhile. Indeed, numbers alone do not necessarily render a class unmanageable. In *Eisen* the Court of Appeals thought that it did, but the Supreme Court did not endorse this aspect of the Court of Appeals' judgment. The question decided in *Eisen* is whether personal notice must be given.[180]

179 *Id.* at 1177.

180 This narrow construction of the case is adopted by several American commentators as well; *see e.g. Eisen IV: Don't Believe the Headlines*, 271 BNA Sec. Reg. & L.

What the court in general must decide is whether the four criteria in Rule 23a are made out and in addition that common questions predominate and that a class action is superior to other available methods for the fair and efficient adjudication of the controversy.[181] If there is a less disruptive means of doing so, it should be adopted. In a case where it is difficult to define a class closely, or where very large numbers of potential plaintiffs are involved, the test case may prove to be an acceptable alternative, with notice given to all other class members if liability is established. (If the defendant prevails, other class members may try again.)[182]

The point is that not one but several procedures are open for litigating the issue, and that even in the class action subclasses may be used. From the point of view of private recompense, Rule 23 machinery seems to work well. When one seeks to make the machinery work primarily in aid of public purposes such as deterrence or the denial of unjust enrichment, one risks incidental distortions of an undesirable character. One limits either the devices which can be adopted in aid of recovery or the limits of recovery which can be allowed. It would in my submission be preferable not to expand the device. It seems appropriate also to point out that the empirical data available concerning the class action is fragmentary. We know very little about the extent to which large recoveries may be anticipated or their economic effects, or the impact of large class suits on court schedules, and the like.

If it is desired to make extended provision for class actions, some of the obscurities of Rule 23 might be dealt with. For example, while it is settled that district courts cannot conduct preliminary trials on the merits with a view to determining whether actions should proceed as class actions, the issue continues to crop up in various ways. In particular, courts have experienced difficulties in determining whether common questions of law and fact both appear and predominate. These issues must be decided at an early stage. The rule seems to be that although the judge may have to speculate to some extent, his decision will not be interfered with provided that he has sufficient material before him to reach a

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Rep., October 2, 1974, at B-1; *Eisen IV: Class Actions One Year Later*, 711 BNA Antitrust & Trade Reg. Rep., April 29, 1975, at B-1; Scott, *Two Models of the Civil Process*, 27 Stan. L. Rev. 937 (1975); *cf.* Dam, *Class Action Notice: Who Needs It?*, [1974] Sup. Ct. Rev. 97, who nonetheless believes that the decision will prove discouraging.

181 *See further* Kamm v. California City Development Co., 509 F.2d 205 (9th Cir. 1975).

182 *See generally* Katz v. Carte Blanche Corp., *supra* note 153.

(tentative) conclusion and bases his ruling on that material.[183] We might make explicit provision to this effect.

In my submission it is also imperative that we deal with the issue of materiality or reliance. Here I advocate that in the cause of action or in the class action rule we provide that a plaintiff in any action based on misrepresentation be required only to demonstrate materiality. The rule in *Blackie v. Barrack* should apply generally; its adoption is a practical necessity.[184] The safeguards are first, the ability of the defendant to prove nonreliance by the plaintiff, second, the upper limit to damages and, if the ALI draft is followed, the fact that there will not have been a breach of the code, in insider trading cases at least, where the defendant believes (on reasonable grounds) that a fact of special significance was generally known or known to an identified other party to the transaction. In short, liability under the ALI scheme for this proposal, would not be arbitrary and unfair.

The matter of costs also requires attention. In the absence of a contingency fee system the possibility of even a successful plaintiff not being awarded enough in costs to satisfy his legal expenses is likely to prove a considerable deterrent to anyone seeking to bring a class action. In a report to the Consumers' Association of Canada, Professor N. Williams concludes that two steps might be adopted:

(1) to adopt a special rule for class actions whereby the defendant would be ordered to pay costs to the plaintiff on a solicitor-client basis which would give the plaintiff a complete indemnity for his costs;

(2) to provide legal aid to the plaintiff for some of his costs, at least to the extent that the costs recovered from the defendant are inadequate to meet the costs the plaintiff must pay to his own lawyer.

Both suggestions are worthy of further exploration.[185]

Another procedural change might be the introduction of the contingency fee. This is probably an essential innovation if class actions are to be pursued aggressively enough to act both as a compensatory and deterrent device. But, as Professor K. Dam delicately notes, it raises the central policy issue of the role of the plaintiff's lawyer; what it is to be in the enforcement of regulatory legislation and how much entrepreneurial scope the lawyer is to have.[186] With the exception of Alberta, Canadian law societies

183 Blackie v. Barrack, 524 F.2d 891 (9th Cir. 1975).

184 *Id*

185 N. Williams, *supra* note 133, at 36.

186 *See* Dam, *supra* note 180; Dam, *Class Actions: Efficiency, Compensation, Deterrence*, 4 J. Legal Stud. 47 (1975).

have been conservative in these matters. The contingency fee is unlikely to be unanimously adopted in Canada.

17. *Governmental Actions*

The question whether the broader public purposes of the class action might not be best achieved by vesting the right to bring civil actions on behalf of a class of consumers in a protective agency has been raised in a number of quarters, both here and in Europe, though in Europe the action does not lie in damages.[187] A first step has been proposed in this regard by Ontario.[188] In order to enforce a liability to a reporting issuer deriving from the misuse of inside information, or, in the case of a mutual fund, deriving from insider information pertaining to the fund, the High Court may on application permit a securityholder of the reporting issuer or the Ontario Securities Commission to bring action on behalf of the reporting issuer. In any case it must be shown either that the reporting issuer (or mutual fund) refused to bring an action within sixty days of a demand upon it to do so, or failed to prosecute it diligently. The costs may be ordered to be paid by the reporting issuer. In determining whether leave shall be given to bring or continue the action for the benefit of a reporting issuer, the judge shall have regard to the potential benefit to be derived from the action by the reporting issuer and the securityholders thereof and the cost involved in the prosecution of the action.[189] The purpose of the action is therefore plainly compensatory rather than deterrent. It is similar to section 37 of the United Kingdom Companies Act 1967 which enables the Department of Trade and Industry, following an investigator's report, to bring a civil action in the name and on behalf of a body corporate where it appears desirable to do so in the public interest, and to section 100.5 of the Canada Corporations Act. It overrides a decision by the controller not to sue and could certainly enure to the benefit of creditors. The repository of any recovery is conveniently indicated, the company, and the ultimate distribution will be to creditors and shareholders in proportion to their claims. The section, potentially useful, has no revolutionary significance. Nonetheless, it could prove to be a powerful regulatory device if rigorously used.

Elsewhere in the field of securities, what claims would be

187 Dam, *supra* note 180; Eisen v. Carlisle and Jacquelin, 479 F.2d 1005 (2d Cir. 1973) (*per* Medina, C.J.); on French law *see* de Poulpiquet, *Le droit de mettre en mouvement l'action publique; conséquence de l'action civile ou droit autonome*, REVUE DE SCIENCE CRIMINELLE ET DE DROIT PÉNAL COMPARÉ 37-57 (January-March 1975).

188 Ontario Bill 30, cl. 134.

189 *Id.* cl. 6.

pursued, whose interest is to be vindicated, and to whom ought recovery to go? The causes of action of which we speak may be incredibly diverse. For example, we could be speaking of dealers who cause loss by manipulating customers' accounts, or of issuers who file false prospectuses, or of insiders who intentionally or otherwise manipulate a market or who issue misleading statements at a time when their stocks are being traded.

So far as insider liabilities are thought to produce claims by the insiders' corporation the corporation is, as we have noted, a suitable repository for recovery. But in a situation in which it is desired to pursue individual claims in the insider situation the desirability of such machinery is less clear. For, on whose behalf would the claim be advanced, what quantum of damages would be appropriate, how would causation and loss be proven? The difficulties of inducing ordinary private persons to bring class actions would be surmounted, but one would not necessarily solve the potential difficulties implicit in the unregulated class action.

One solution might be to enable an agency to take over or commence civil litigation, subject to satisfying the court that the claimants whose rights it vindicates have requested such action and that it is in the public interest that the action be allowed to proceed. Provision could be made once the cause of action had been proven, for others to file claims, and for determination of the total recovery to be deferred long enough for claims to be filed and proven. This would involve claimants in proving that they fell within the class to which the judgment related, that they relied, and that they suffered loss. Proof could be facilitated by allowing proof by affidavit, subject to cross-examination by the defendant if desired. Very small claims would probably not be advanced because to do so would be somewhat time-consuming and the financial benefit, after costs of proof, exiguous. The defendant would ultimately pay only the sum due to claimants plus costs. There would be no residue for distribution *cy pres*. It is perhaps less likely, than under some proposals, to result in colossal damage awards of a severely disruptive character.

In determining whether the public interest dictates that the agency should be allowed to bring an action, the nature and extent of any alleged wrongdoing; the amount of recompense to individual plaintiffs, the dictates of deterrence and the availability of alternative machinery could all be taken into account. A court might well be able to conclude that the public interest did not warrant such an action. For example, where what was in issue was a press release drafted in haste and in innocence, it might be though that deterrence and the enforcement of standards of care did not require public intervention. At the same time a private

action on behalf of a person substantially damnified, or even a class, could proceed subject to the normal hazards of litigation such as proving that there really was a cause of action. The agency would initially be faced with a hurdle; that of demonstrating to the court that on balance it is in the public interest that it be allowed to bring a particular action.

Some heads of public interest have been mentioned; another might appear where numbers of economically deprived persons were mulcted of appreciable sums of money, or where persons manipulated a governmental scheme designed to protect a class of persons as in *Affiliated Ute*. As Dam notes, some machinery would have to be devised in cases where both governmental and private actions were in train, to deal with the problem of overlapping recoveries. We would also need a rule to deal with cases in which the same conduct attracted suits for damages on behalf of individuals and a suit by the insider's corporation based on restitutionary principles. We may have to consider limits to recoveries, priorities if any in the execution fund and the like.

A further and fundamental point arises. This paper discusses such matters as improved class action procedures and allied devices. Few if any provincial rules of court are very advanced in these areas. Normally, actions under federal statutes would fall within the concurrent jurisdiction of provincial Supreme Courts and the Federal Court of Canada. But as it may prove difficult to secure the desired unanimity in provincial rules concerning class action, it may be best to invest the Federal Court with exclusive original jurisdiction in civil matters arising under any federal securities code. Presumably, it would be possible to procure a suitable class action rule under the rules of the Federal Court, or make special provision for this in the statute itself. Inconvenience to litigants is minimized by section 15 of the Federal Court Act by which the court sits in any place in Canada. If we are to suggest substantial changes in modes of procedure, we will, I think, have to centralize jurisdiction. In addition, if we are to rely upon such matters as class actions it might be easier to secure greater consistency in the application of standards via one court than several.

C. INJUNCTIVE AND ANCILLARY RELIEF

There is an obvious need, under any regime of securities regulation, for a power to prevent individuals from carrying on unlawful activities, either at the particular time or in the future or both. Where the activity involved results in the collection of a fund from the public which is put at risk, or the exaction of an unlawful profit, or the obtaining of securities which may, by further dealing

in the course of trade deprive the victim of redress via rescission, there arises also a need for ancillary relief in order to preserve the *status quo* pending final relief. The SEC tackles these problems via the injunction, the utility of which goes far beyond its avowedly deterrent purpose. This is also a feature of section 1515 of the *ALI Federal Securities Code*. Those current provincial statutes modelled upon Ontario give the general powers to apply to the High Court for power directing compliance with the legislation, and powers to freeze assets, appoint receivers, managers, and trustees of property in the hands of broker-dealers.

In some respects the SEC and the provincial administrators achieve similar coverage. The sweep of U.S. law is greater which must be taken into account in evaluating the system. The greatest single advantage of the injunction procedure as it exists in the United States is its use as a prospective civil disability measure, which refers not only to the deprivation of a person from an entitlement to act as a broker-dealer, but also limits the range of activities in which corporate insiders can engage. Both branches are important. It must, however, be remembered that administrative proceedings can only be taken against registrants. For transgressions by others, civil and criminal proceedings must be resorted to.

Under our most modern provincial legislation, provision is not made for injunctive proceedings as such. The most recent proposals in Ontario Bill 30 clause 16 specify that assets may be frozen and a receivership application made under the following circumstances:

(1) When a provincial Commission is about to order an investigation under *e.g.*, clause 11 or 13 or during or after an investigation.[190]
(2) Where it is about to make or has made an order under clause 16(1)(a) that trading in securities of an issuer shall cease.
(3) Where under clause 16(1)(c) the commission is about to make or has made a direction, decision, order or ruling suspending or cancelling the registration of any person or company or affecting the right of any person or company to trade in securities.
(4) Where criminal proceedings or proceedings in respect of a contravention of the Securities Act or Regulations are about to be or have been instituted by any person or company, that in the opinion of the commission are connected with or arise

190 Seemingly, this means that no such order may be made while an investigation under s. 3 is being contemplated by the Minister. The omission was no doubt

out of any security or trade therein or out of any business conducted by such persons or company.

Given the existence of the required conditions, the commission may, it is proposed, in writing or by telegram, direct persons to hold funds or securities of the respondent, or to refrain from withdrawing them from any person having them on deposit, under control or for safekeeping, or to hold them in trust for an interim receiver or trustee.[191]

The commission may also by clauses 17(1) and (2), under the like circumstances, apply to a judge of the Supreme Court for the appointment of a receiver and manager and trustee of the property of such person or company. This jurisdiction may be exercised where the judge considers such an appointment to be in the best interests of the creditor or of the person or company whose assets are being affected. Provision is also made by clause 17(3) for a fifteen-day order which can be made by the judge upon an *ex parte* application by the commission. By clause 17(4) a receiver and manager so appointed shall have authority, if directed by the judge, to wind up or manage the business and affairs of the person or company. By clause 17(5) the order made may be enforced by contempt procedure if required. This is apt to invoke a wide aiders and abettors doctrine.[192] An order made under the section may be enforced in the same manner as any order or judgment of the Supreme Court and may be varied or discharged upon an application made by notice.

In addition, there is power under clause 125 of Ontario Bill 30 for a judge, on application by the commission, to direct by order any person or company which has failed to comply with or is violating any provision of the act or regulations, to comply with the act or regulations, or restraining him or it from violating such provision. The judge may make such order "or such other as the judge thinks fit". There is an appeal to the Court of Appeal.

Section 1515 of the U.S. *ALI Federal Securities Code*, which is essentially a consolidation of existing legislation, provides that the commission may bring an action to enjoin a violation or enforce compliance with the code. The grounds for issue are either that the defendant's past conduct indicates a reasonable likelihood of future violations or that the defendant is apparently engaged or is

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deliberate, because the commission cannot know that an order will issue. Note that the same structure of powers is contained in cls. 11 and 30 of Ontario Bill 30.

191 Clause 16(2) permits a person in receipt of such a direction to apply to the commission. Clause 16(4) permits notification to the appropriate official where proceedings are about to be taken in respect of mining claims or land.

192 *See* Ronson Products Ltd. v. Ronson Furniture Ltd., [1966] 2 W.L.R. 1157 (Ch.) and cases cited therein.

about to engage in unlawful practices.[193] Provision is made for the bringing of actions on behalf of investment companies, in particular against controllers for breach of fiduciary duty. A trustee of such company may be appointed by the court in any such action. The commission may bring an action to enjoin the consummation of a plan of reorganization of such company. Further provisions deal with the liquidation of unit investment trusts, and holding company reorganization. The commission may bring an action or intervene in any action in order to prevent indemnification or contribution not required or authorized by the code, *e.g.*, a contract which indemnified officers against liability occasioned by bad faith, misfeasance, gross negligence, or reckless disregard of the duties involved in the conduct of his office by the insider. Finally, in section 1515(i) there is a general provision for ancillary relief. The section provides in part:

> "In an action created by or based on a violation of the Code, whether or not brought by the Commission the court has the authority of a court of equity to grant appropriate ancillary or other relief, including an accounting, a receivership of the defendant or the defendant's assets, and restitution...."

The *SEC Annual Reports* note that injunctions are sought where a violation of the anti-fraud provisions is alleged, or there are alleged violations of the financial responsibility, net capital or bookkeeping requirements, or other investor protection requirements.[194] The relief sought in actions against broker-dealers includes an order to put in a receiver to freeze assets and to obtain an accounting. In the case of mutual fund corporations and broker-dealers a receiver may be sought in order to oust persons guilty of mismanagement, where investors' interests are likely to be impaired by their continuation in office.[195] Orders for rescission and requiring the disgorging of unlawful profits may be sought. While the SEC does not bring action on behalf of individuals, its own actions may serve to vindicate private rights.[196]

It must be remembered that American legislation, especially as it has been interpreted by the courts, penetrates deep into the interstices of corporation law. The securities laws, in particular section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 were not however intended to deal with ordinary corporate

193 ALI Federal Securities Code, Tent. Draft No. 3, at 92-93.

194 SEC, 26th Annual Report 123-25 (1960); SEC, 35th Annual Report 125 (1969); SEC, 36th Annual Report 108 (1970); SEC, 37th Annual Report (1971).

195 SEC, 28th Annual Report 131 (1962); SEC, 38th Annual Report 118 (1972).

196 SEC, 38th Annual Report 118 (1972).

mismanagement.[197] Enforcement action there by a regulatory agency has a wide ambit. Furthermore, the ultimate sweep of the injunction, especially as coupled with ancillary relief of one form or another, has not been determined. The injunction against improper dealings in securities is well established. So too is the use of the injunction essentially as a warning measure, in the case of negligently misleading press releases, though here as will be seen some doctrinal edges are blurred.

The issue of such an injunction may conduce to greater care. In addition, it would be impercipient to overlook the result that successful injunctive proceedings before the Federal Courts could have in a private damage suit. Assuming that the ingredients of liability are settled, such a decree could well induce a settlement of the private litigation. The injunction action has been used, in the case of a public financing, to enjoin persons from violations of anti-fraud and prospectus filing requirements; to order the disgorging of proceeds, profits and income derived from the sale of the corporation's stock, to appoint a trustee to receive these funds and distribute them to defrauded public investors, and to freeze the corporation's assets until such time as the proceeds are transferred to the trustee.[197a]

The ability to restrain persons from committing acts which are of the same type as those which the respondent is found to have committed functions as a form of civil disability measure. This aspect, of disabling wrongdoers, appears also in *SEC v. Bowler*. This was an action based on breach of the anti-fraud provisions for an injunction and receivership. It was alleged that substantial nondisclosure, failure to register, plus intercorporate transfers and other abuses, had enabled corporations in a family group to appear in a more favourable light than they deserved. The respondents filed a plea of reorganization which the trial judge accepted. He granted the injunction but refused the receivership. On appeal, it was held that the trial judge erred in approving the reorganization and refusing the receivership. In part this determination was based on the consideration that the principal malefactor would still retain an active, if not decisive, part in the corporation's affairs. The court thus states:[198]

> "At most, his domination would be diluted for only a period of three years. Certainly, the limited injunction against improper security dealings would provide no brake against mismanagement, other than security deal-

197 SEC v. Manor Nursing Homes Inc., 458 F.2d 1082 (2d Cir. 1972).
197a *Id.*
198 427 F.2d 190, 197 (4th Cir. 1970).

> ings in violation of the Securities Act 1933, after the expiration of that period."

The use of the injunction as a general civil disability measure is limited by the consideration that the injunction must be drafted with sufficient particularity to convey clearly to the person enjoined what precisely he may or may not do.[199] Injunctions cast too widely are subject to attack.

Ancillary remedies in the United States presently take one of three basic forms:

(1) remedying of past abuses;
(2) prevention of further fraud by requiring the adoption of special corporate procedures;
(3) the temporary appointment of special agents in cases of gross mismanagement requiring unusual control or the wholesale replacement of existing management.

Once the injunction power has been competently invoked, the court has power to award all equitable relief necessary in the circumstances, including, as in *SEC v. Texas Gulf Sulphur Inc.*,[200] a disgorging of insider profits. Through the device of consent decrees the SEC has gone even further, obtaining for example the appointment of receivers, limited receivers for disclosure purposes, the appointment of special auditors and masters, of special counsel, and an order for the election of new directors satisfactory to the SEC and to the court. One commentator states:[201]

> "In each instance, the result is the imposition of a quasi-governmental layer of authority which deprives incumbent management of its absolute control over the internal affairs of the corporation, although perhaps not totally displacing incumbent management with a court-appointed receiver."

The logic of such developments is clear. Receivership is a useful means of preserving companies from further harm. An order appointing directors enables vigorous management policies to be pursued.[202] It is, however, improbable that we would wish to venture so far into what has traditionally been thought of as corporate law, with the danger not merely of supplementing but of contradicting existing company law provisions. For example, one might well encounter provisions which required, on the removal of directors, an immediate appointment by the shareholders or by a provincial officer. There is a case for restraint here, espe-

199 Williams v. U.S., 402 F.2d 47 (2d Cir. 1967).
200 401 F.2d 883 (2d Cir. 1968).
201 Treadway, *SEC Enforcement Techniques: Expanding and Exotic Forms of Ancillary Relief*, 32 Wash. & Lee L. Rev. 637, 652 (1975).
202 Note, *Equitable Remedies in Enforcement Actions*, 123 U. Pa. L. Rev. 1188 (1975).

cially as the provinces are unlikely to be quiescent concerning areas in which they have been closely associated.[203]

What matters must be proved in order to obtain an injunction? The mental element is important. The decision of the Supreme Court of the United States in *Ernst and Ernst v. Hochfelder*[204] that *scienter* is required for civil liability has led to a reassessment of the ingredients necessary to support an application for an injunction. One of the statutory criteria for an injunction is that there has been a violation of the securities laws. If a violation requires *scienter* in the sense of recklessness at least, it follows as a logical matter of statutory interpretation that an infraction which was at least reckless be proven in addition to proving that harm is likely in the future. Several U.S. cases interpret the requirement in this fashion.[205] Circuit courts of appeal and commentators are inclined to seek a way of circumventing the problem having regard to the remedial purposes of injunction procedure.[206] The better solution, as a matter of drafting, would, I submit, be to key the procedure to the phenomenon, that is, has manipulation for example occurred in fact? If so, and if there is danger of repetition, a matter to which *scienter* is plainly relevant, a court should be able to award an injunction together with such ancillary relief as appears necessary.

No court has held in terms that mere proof of a past violation is sufficient to found relief. It has been said that proof of illegal conduct in the past is suggestive of a propensity to commit future violations and that when once a previous violation has been proved the burden passes to the defendant to provide the court with some basis for believing that there will not be any repetition of the illegal conduct.[207] In similar vein, it has been held that mere proof of the cessation of illegal activity is not enough to prevent the court from granting an injunction.[208] The standard is, however,

203 Québec, for example, has and asserts such a power; *see, 11-Firm Administrator Is Sought by QSC*, The Globe and Mail (Toronto), April 9, 1975, at B1, col. 3.

204 425 U.S. 185 (1976).

205 SEC v. Cenco, [1977-1978 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 96,133 (2d Cir. 1977); Arthur Lipper Corp. v. SEC, 551 F.2d 915 (2d Cir. 1976); SEC v. American Realty Trust, [1976-1977 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 95,913 (E.D. Va. 1977).

206 *E.g.* SEC v. World Radio Mission Inc., 544 F.2d 535 (1st Cir. 1976); SEC v. Bausch & Lomb Inc., 565 F.2d 8 (2d Cir. 1977); and *see* Berber & Franklin, *Scienter and Securities and Exchange Commission Rule 10b-5 Injunctive Actions: A Re-appraisal in Light of Hochfelder*, 51 N.Y.U. L. Rev. 769 (1976); Harkelroad, *Requirements for Injunctive Actions Under the Federal Securities Laws*, 2 J. Corp. L. 481 (1977).

207 SEC v. Rega, [1975-1976 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 95,222 (S.D.N.Y. 1975); SEC v. Cooper, 402 F. Supp. 516 (S.D.N.Y. 1975).

208 SEC v. Management Dynamics, 515 F.2d 801 (2d Cir. 1975); SEC v. D'Onofrio

whether or not there is a reasonable likelihood that the violation will be repeated. It seems probable that courts, especially in the light of the decision of the Supreme Court in *Rondeau v. Mosinee Paper Corp.* will insist upon a showing that there is a likelihood of repetition and will not infer repetition simply from the fact of a prior breach, though that continues to be a persuasive circumstance.[209] In Ontario the court of appeal has held that where an injunction is sought in order to prevent a breach of statute, the usual criteria of balance of convenience and irreparability of apprehended damage are irrelevant.[210]

If it is desired to take powers requesting courts to grant ancillary relief, I conclude that we must specify plainly in the legislation which the requisites for liability are to be, avoiding a need to prove prior wilful breaches, and what powers we want. We certainly need powers to ban persons from acting in the securities industry, either as officers of issuers or as members of the exchanges or as dealing with the public as licensed dealers. We certainly need to determine what the conditions for injunctive or other relief are to be. It is noteworthy that both in the field of securities regulation and pollution one finds suggestions that proof of past violations should either found relief or at least give rise to a rebuttable presumption that relief is required.[211]

Ontario Bill 30 proposes that the issue of an order under clauses 16 and 17 of Act in some cases accompanies an order cancelling or suspending registration; in others it will be followed by proceedings giving rise to such an order. It is proposed that where clause 126 is invoked, a court order would not result in a final determination of the merits, but the commission might eventually determine to discipline a registrant or deny exemptions. The result as it would affect registrants is not dissimilar to that which is produced by the grant of an injunction in the United States. An injunction is cause for denial, suspension or rescission of the registration of any broker or dealer.[212] A self-regulatory association must by rule provide that a person enjoined shall not be admitted to or continued in membership of the association as a

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[1975-1976 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 95,201 (S.D.N.Y. 1975); CFTC v. J.S. Love Options Ltd., CCH Comm. Fut. L. Rep. ¶ 20,198 (S.D.N.Y. 1976).

209 422 U.S. 49 (1975); and *see* SEC v. Penn Central Co., 425 F. Supp. 593 (E.D. Pa. 1976).

210 A.G. of Ontario v. Grabarchuk, 11 O.R. (2d) 607 (Div'l Ct. 1976).

211 *See* 302 BNA Sec. Reg. & L. Rep., May 14, 1975, at A-1 (recording the opposition of prominent members of the securities bar to the suggestion); *see also Burdens of Proof in Environment Litigation, Hearing Before the Sub-Committee on Environment of the Senate Committee on Commerce*, 93d Cong., 2d Sess. (November 19, 1974) (Serial No. 93-126) (on S. 1104 Amend. No. 1814).

212 Securities Exchange Act of 1934, s. 15(b)(5)(A).

broker-dealer without the approval of the commission.[213] In the case of nonmember registrants, the SEC has wide powers; the effect of an injunction can be the removal of directors from office in particular companies for substantial periods of time. It is possible for orders to go regulating their conduct in some respects over a period of time. There is a question of how far it is desired to enter the field of what is traditionally thought of as corporate law. But, in some respects, the power to intervene in management is essential. Mutual funds afford a ready example. It would be advantageous to have a general civil disability provision in such an area. An injunction proceeding which might help to ease the way for private litigants could prove useful, directed as it would necessarily be to particular wrongful acts performed in breach of the securities laws. This is one aspect in which the injunction is superior to existing provincial procedures. Another lies in the extent of ancillary relief which is available. The utility of this, the ability to order rescission, etc., depends ultimately on the structure of legislation which it is proposed that we adopt.

Most SEC injunction applications are dealt with on a consent basis. The order usually goes by consent and follows the kind requested in the prayer. The defendant usually declines to admit facts. The commission will not accept a consent where the facts are positively denied and, indeed, it seems unlikely that a court could make a consent order in such a case. It is pertinent to note that the practice of accepting consent decrees without any admission of facts detracts from the value of injunctive proceedings to prospective civil litigants. One advantage of settlement procedure is however, that a consent decree may be so drafted as to provide for restitution to defrauded customers.

As such an injunction can form the basis of disciplinary proceedings against a registrant, it is prejudicial to him. The danger of coercion can in part be met by judicial oversight of consent decrees.

Would injunction procedure at the behest of a centralized agency prove sufficiently expeditious? There is no reason why it should not. SEC regional offices do not encounter difficulty. Instructions, pleadings, etc., can go from the head office to the regions by telecopy. Orders can be obtained very quickly. There seems to be little reason to fear inhibiting delay.

Another aspect of the enforcement problem is trading in dubious securities by nonregistrants which is presently dealt with either by a general cease trading order[214] or by an order denying

213 *Id.* s. 15A(h)(4)(B) read with the provision in note 212 *supra.*
214 Ontario Securities Act, s. 143.

exemptions. The effect of the former order is similar to an injunction. It is interesting to note that in 1970 the Ontario commission announced its readiness to invoke stop trading procedures where, *inter alia*, persons traded on the basis of undisclosed insider information.[215] We thus begin to approach the U.S. position more closely. The effect of this latter procedure is to bring into motion the whole paraphernalia of regulation.[216] In either event breach is punishable. The matter could, if desired, be dealt with formally by injunction, or indeed by a combination of both procedures. What is needed is a procedure whereby trading in suspect securities can be forbidden on a continuing basis until the commission is satisfied that trading should be allowed. The great advantage of an injunction is that it attracts a wide aiding and abetting doctrine while the denial of exemptions affects only the person against whom it is made.[217] This weakness can be overcome by a general cease trading order buttressed by adequate criminal and administrative penalties.[218] The Quebec Securities Commission seems to make considerable use of this sort of device, preventing extensive lists of persons from trading in securities which are thought to have been manipulated. The order may go against all persons trading in the stock, or against certain persons only.[219]

Under clause 126 of Ontario Bill 30, the commission would be able to impose a cease trading order for such period as is specified in the order. It could do so notwithstanding that a company has complied with clause 76(3) and forwarded a continuous disclosure report. Except where the length of time required for a public hearing could be prejudicial to the public interest a cease trading order is not to be made until after a hearing has taken place.[220] A similar safeguard surrounds clause 127 granting the commission

215 *See* Notice, Timely Disclosure [1970] OSC Bull. 145, 146 (November).

216 *See e.g.* Re Mercantile Bank & Trust Co., [1973] OSC Bull. 173 (October); and *see* [1972] OSC Bull. 6 (January) in which it is noted that denial of exemptions is one way of inducing persons to file insider reports. Re Midgaul Ltd., [1970] OSC Bull. 91 (June) is a case in which a denial of exemption order was used in a case of suspected fraud.

217 Re West Plains Oil Resources Ltd., [1965] OSC Bull. 18 (November).

218 This particular area is replete with international problems and is covered in *Hebenton and Gibson*; and *see* Re Tipuani Gold Mines Ltd., [1974] OSC Bull. 35 (March); Re Chemalloy Minerals Ltd., [1974] OSC Bull. 60 (March).

219 *E.g.* Re Fort Norman Exploration Inc., 6 QSC Bull. No. 48 (decision 4970, December 1, 1970); *QSC No-Trading Edict New Blow for Sidney Rosen*, The Financial Post (Toronto), April 19, 1975, at 27, col. 1. There are a number of further examples. In the *Rosen* case, the order was coupled with a request for the appointment of an administrator for a number of public companies.

220 After an order has been imposed, the person subject to it bears the onus of showing cause why it should be revoked; *see* Re Panacea Mining and Exploration Ltd., [1971] OSC Bull. 156 (October); Re Rodney Gold Mines Ltd. [1972] OSC Bull. 159 (H.C. July); Re Canusa Holdings Ltd., [1971] OSC Bull. 173 (October).

the power to revoke exemptions. The precise purpose of the cease trading order is not specified in the legislation; whether it exists merely to force compliance with reporting requirements or for other purposes. I am informed that it is extensively used, even in situations where its invocation could be harmful to individual investors.[221] This is not a matter upon which this writer feels competent to deal further. It is perhaps worth noting that when the matter was raised before a committee of the Ontario legislature, H.S. Bray of the Ontario Securities Commission defended the practice as a nonpunitive means of stopping trading in a market affected by rumours until such time as accurate information could be released. He admitted that the order was used in cases of fraud, but these were few, of the order of six to ten *per annum*. The commission does not like using the power for this purpose but occasionally finds it necessary to do so.[222] The power does seem a useful one to have to deal with suspected manipulations, and one would expect a commission to have such a power, as indeed should the stock exchanges.

D. ADMINISTRATIVE SANCTIONS AGAINST BROKER-DEALERS

Securities legislation typically makes provision for the imposition of administrative sanctions. Such sanctions may be imposed either in conjunction with criminal or civil proceedings, or alone.

Under the Securities Exchange Act of 1934 as amended in 1964, the SEC has available to it a wide range of administrative sanctions which it may impose on broker-dealers and other persons. There is similar power under the Investment Advisers Act of 1940 as amended in 1970. These broad powers are incorporated in the *ALI Federal Securities Code*. The SEC may deny a broker-dealer's application for registration. The SEC may impose sanctions upon registered broker-dealers ranging from censure to suspension or revocation of registration and it may suspend or terminate a broker-dealer's membership in the NASD. In addition, it may suspend or bar any person from association with a broker-dealer, or censure him. This is an additional power inserted in 1964. Before that date such persons could only be named as a cause of a broker-dealer's violation. A similar range of powers exists under Canadian legislation.[223]

Generally the SEC may, under section 15(b) of the Securities Exchange Act of 1934 as amended, impose sanctions only if, after

221 I am indebted to Prof. Warren Grover for information on the point.

222 Leg. Ont. Deb., 29th Leg., 5th Sess. No. S-29, at 843-54 (1975).

223 *E.g.* Ontario Bill 30, cls. 19-32 which generally reproduce provision in the Ontario Securities Act.

notice and opportunity for hearing, it finds: (1) the accused wilfully violated or aided and abetted violations of any provision of the Securities Acts or rules thereunder, or is subject to certain disqualifications such as a conviction or injunction relating to certain types of offence and, (2) that a particular sanction is in the public interest. The hearing requirement features in Canadian legislation as well. Often matters are dealt with without hearings where the accused waives his rights to a hearing and submits an offer of settlement. In 1971, 264 administrative proceedings were taken against broker-dealers and investment advisers.

Proceedings may also cover the adequacy of disclosure in a registration statement or in reports filed with the SEC. Such cases may lead to an order suspending effectiveness of a registration statement or directing compliance with reporting requirements.[224] The SEC also has the power similarly to suspend trading where the public interest so requires. The SEC tries to gear sanctions in both contested and settlement cases to the circumstances of the case. It may limit the sanction to a particular branch office of a broker-dealer rather than the entire firm, or prohibit only certain kinds of activity by the broker-dealer rather than the entire firm, or prohibit only certain kinds of activity by the broker-dealer during a period of suspension, or only prohibit an individual engaging in supervisory activities.

The SEC does not take disciplinary action in every violation. It does, however, proceed promptly if the violation appears to be wilful and the public interest is best served by formal action against the broker-dealer. Similarly the SEC does not impose formal sanctions in every case in which proceedings are taken. This abstention is found especially in cases of failure of supervision where the firm adopts suitable internal controls to reduce the risks of any recurrence of injury to investors of the type found and where a further sanction against the firm would harm innocent people. The same comment is true of OSC practice.[225] In the case of some technical violations such as unwitting breach of the net capital rules, the commission gives the violators an opportunity to comply. Failure to do so results in the imposition of formal sanctions.[226] The SEC has in the past required as a condition of staying sanctions that the firm dissociate itself from the members of the executive committee found to be at fault either permanently or for a period of time during which such members do not receive any pecuniary benefits from the firm.

224 SEC, 38TH ANNUAL REPORT 70 (1972).

225 *E.g.* Re Davidson, [1972] OSC Bull. 7 (January); Re United Inv. Sec. Ltd., [1972] OSC Bull. 20 (February).

226 SEC, 26TH ANNUAL REPORT 105 (1960); SEC, 27TH ANNUAL REPORT 81 (1961).

The *SEC Annual Report* for 1972 notes that the commission will impose formal disciplinary sanctions where:

(1) there has been a wilful violation of the provisions of or a rule made under the Securities Acts; or
(2) a failure to supervise in a reasonable manner another person who committed a violation;
(3) where a respondent has been convicted for, or enjoined from, certain types of misconduct;
(4) where there is inadequate disclosure in a registration statement or report filed with the commission.[227]

In the latter case the commission may suspend the effectiveness of a registration statement or direct compliance with registration requirements. The *ALI Federal Securities Code*, section 1505 contains similar provisions. The list thus extends beyond fraud to incompetence. The commission, like its Canadian counterparts, also has the power summarily to suspend trading in a security when the public interest so requires.

Some aspects of SEC practice have become well settled. Wilful violation of the antimanipulation provisions generally merits expulsion. This, in the light of such cases as *Cady, Roberts & Co.*, helps to put real teeth in the insider rules.[228] The administrative response to *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith*[229] which preceded the judicial decision and in which the firm entered a stipulation of settlement and accepted discipline makes it clear that broker-dealers cannot utilize inside information for their own benefit or for that of their clients. Practices which would be considered blatant violations of the rules merit revocation. Such, for example, are the sale of unregistered control shares, that is, distribution without a prospectus, and the filing of false and misleading statements;[230] the use of high pressure tactics and statements, in particular the use of unfounded financial forecasts;[231] and failures of supervision resulting in fraud.[232]

227 SEC, 38TH ANNUAL REPORT 72 (1972); *PLI Securities Law Institute*, 7 REV. SEC. REG. 820, 825 ff. (1974) notes that in 1967-69, SEC discipline cases against broker-dealers in fraud cases produced 48% expulsions and 52% suspensions. In nonfraud cases, 16% were expelled and 84% suspended. There seemed to be a bias in favour of New York Stock Exchange members and broker-dealers. One suspects that the figures are crude and need further analysis.

228 *See* Daum & Phillips, *The Implications of Cady, Roberts*, 17 BUS. LAW 939 (1962); Jacobs, *The Impact of Securities Exchange Act Rule 10b-5 on Broker-Dealers*, 57 CORNELL L.J. 869 (1972).

229 *See* note 171 *supra*.

230 *See* the material cited in note 227 *supra*.

231 SEC, 30TH ANNUAL REPORT 67 (1964); SEC, 31ST ANNUAL REPORT 65 (1965); SEC, 32D ANNUAL REPORT 60 (1966); SEC, 33D ANNUAL REPORT 78 (1967).

232 Re Shearson, Hammill & Co., reported in SEC, 32D ANNUAL REPORT 58 (1966); Re Collins Securities Corp., SEC, Securities Exchange Act of 1974 Release No. 11766,

The use of high pressure tactics is particularly deprecated by all securities agencies because it is inconsistent with the obligation of a broker-dealer to know his client.[233] It is generally considered to be very improper to recommend securities which do not meet the needs of a customer who has informed the broker-dealer of them.[234] Churning is also a cause for revocation.[235] So also are wilful violations of the net capital rule which is seen as a substantial rather than a mere technical provision.[236] The same comment applies to violation of the registration requirement provisions. Breach of these is serious and a ground for revocation.[237]

The same emphasis (apart from the matter of insider trading) is also evident from the OSC Bulletins. Default in supervision,[238] failure to consider clients' interests, including overloading and high pressure sales methods;[239] participation in the distribution of unregistered securities and failure to deliver proper confirmations;[240] the conduct of a "classic" pooling operation designed to result in an artificial scarcity;[241] failure to meet filing requirements;[242] failure to meet conditions of registration and net capital and contingency fund participation (in the case of a mutual fund);[243] improper dealing with a client's account for the broker-dealer's own purposes;[244] failure to meet net capital requirements;[245] unauthorized trading by Ontario registrants into other

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October 23, 1975, [1975-1976 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 80,327 where, however, it is pointed out that the principal will not be liable if he reasonably delegates a function and neither knows nor has reason to know that the delegate is not properly performing his function; Re John R. Brick, SEC, Securities Exchange Act of 1934 Release No. 11763, October 24, 1975, 8 SEC Docket 248.

233 There are a number of cases of this sort in British Columbia. *See e.g.* Re Ginetti, B.C. Corp. and Financial Services Comm'n Weekly Summary, August 22, 1975, at 1; Re Groberman, B.C. Corp. and Financial Services Comm'n Weekly Summary, November 28, 1975, at 1.

234 SEC, 34th Annual Report 93 (1968).

235 SEC, 28th Annual Report 66 (1962); SEC, 36th Annual Report 102 (1970).

236 Blaise d'Antoni & Assoc. Inc. v. SEC, 289 F.2d 276 (5th Cir. 1961).

237 Financial Counsellors Inc. v. SEC, 339 F.2d 196 (2d Cir. 1964).

238 Re Davidson & Co., *supra* note 225; Re H.E. Smith Securities Ltd., [1970] OSC Bull. 166 (December); Re Martell Investment Co., [1969] OSC Bull. 123 (July); Re Robertson, Malone & Co., Ltd., [1968] OSC Bull. 254 (November).

239 Re Ramras, [1972] OSC Bull. 123 (June); Re McNairn, [1968] OSC Bull. 24 (February); Re McLarty, [1968] OSC Bull. 9 (January); Re Adelaide Securities Ltd., [1968] OSC Bull. 54 (March); Re Lusty, [1967] OSC Bull. 58 (October).

240 Re Glandfield & Co. Ltd., [1972] OSC Bull. 44 (April).

241 Re Hevenor & Co. Ltd., [1971] OSC Bull. 42 (April).

242 *See* Notice, Filings Under pt. XII of the Securities Act, [1970] OSC Bull. 79 (June).

243 Re Financial Planning Associates, [1970] OSC Bull. 119 (August).

244 Re Thomson, [1969] OSC Bull. 160 (September).

245 Re Ord, Wallington & Co. Ltd., [1968] OSC Bull. 109 (April) (in which case interim suspension may be used).

jurisdictions;[246] and, of course, deceptive and manipulative practice generally.

As in the United States, the OSC has been at pains to establish the proposition that registrants and salesmen owe a duty to give dispassionate and informed advice to the public.[247] Similar duties apply to a person who holds himself out as a securities adviser. He is not just a newspaper publisher. He represents himself as qualified to engage in the business of recommending purchase or sale of specific securities at opportune times. In order to give advice he must have relevant information and to give advice knowing that such is not available is improper conduct which can lead to the cancellation of registration.[248]

A rash of such cases occurred in 1966, of which the most celebrated is that of *Goldmack Securities Corp.*[249] It is evident from an examination of the OSC Bulletins that the thrust of the Commission's regulatory activities has gone beyond manipulation into a consistent enforcement of the duties of broker-dealers to the public via the "shingle theory", and to other matters such as duties of supervision and training and the like. The same remarks apply to the activities of the Québec and British Columbia commissions whose published reports testify eloquently to their endeavours to raise standards in the industry. The imposition of a duty to deal fairly with the public is of course essential. In *Do You Sincerely Want to Be Rich*[250] the authors note, not unexpectedly, that high pressure selling and salesman enthusiasm are the most important factors in the client's decision to purchase.

The SEC and the OSC exhibit certain similarities of approach. Thus, as we have noted, formal sanctions are not always imposed, especially where the offender has taken steps to rectify a situation which allowed an infraction to develop.[251] The SEC however appears to rely more extensively on offers of settlement in which restructuring proposals, or limited civil disability measures are advanced by the respondent. We deal with this below. Ontario commonly employs denial of exemptions as a means of terminating undesirable conduct. This in particular is used to control offerings with a foreign element, a topic which forms the substance of the Hebenton and Gibson paper in this volume.[252] As we

246 Re Canadian-American Securities Ltd., [1968] OSC Bull. 230 (October).
247 Re Rotenberg, [1967] OSC Bull. 28 (September).
248 Re Southern Brokerage & Holding Co. Inc., [1967] OSC Bull. 4 (Ont. C.A. June).
249 Re Goldmack Securities Corp., [1966] OSC Bull. 14 (January).
250 C. Raw, B. Page & G. Hodgson, *supra* note 60, at 222.
251 Re United Investment Securities Ltd., [1972] OSC Bull. 20 (January).
252 *See* Re Chemalloy Minerals Ltd., [1974] OSC Bull. 60 (March); Re Belgium Standard Ltd., [1973] OSC Bull. 94 (July); Re Mercantile Bank & Trust Co. Ltd., [1973] OSC Bull. 173 (October); R. v. Goss, [1969] OSC Bull 44 Prov. Ct. April).

have noted orders banning trading in a security are also used, and may be coupled with a denial of exemptions.[253] Denial of exemption procedure is also invoked where it is thought that a fraud is in progress. The burden of proof on such a hearing is simply that the evidence supporting the inference of fraud be clear and convincing.[254]

The SEC and OSC have similar powers over registrants. The SEC seems less accommodating than the OSC, readier to revoke registration while the OSC, from the evidence of its bulletin, is prepared in many cases to suspend registration of principals and salesmen, either with or without conditions, or simply to administer a reprimand. In particular, where the OSC considers that an infraction is attributable to a saleman's ignorance, it often suspends him until he has passed the Canadian Securities Course.[255] An order for suspension may be coupled with an obligation on the respondent's firm to make periodic reports concerning his conduct after the period of suspension has elapsed.[256] Where, however, a salesman has a history of breach of the rules and casual indifference to his duties and obligations as a securities salesman and a bad employment record, his registration may well be cancelled.[257]

A striking apparent difference between the SEC and the OSC lies in the use of the reprimand. This is seldom imposed as a sole sanction by the SEC, but is sometimes so used by the OSC, in particular when remedial steps have been taken.[258] Similarly, the OSC seems readier to use relatively brief periods of suspension against broker-dealers than does the SEC, which appears to be more stringent in its approach. Comparisons would be invidious. One consideration should, however, be recalled. If administrative proceedings are to be used in preference to criminal proceedings in some cases where the latter could be invoked, it may be difficult to justify apparently lenient sanctions to a public imbued with the notion that white-collar offenders are, in general, treated preferentially. In other words, our interest is not solely in whether the industry is being efficiently regulated; we must concern ourselves with wider issues of social justice as well.

A further aspect of the employment of administrative remedies is the availability of remedial sanctions. Thus, the SEC in some cases may impose a remedial sanction; for example, the exclusion

253 Re Panacea Mining & Exploration Ltd., *supra* note 220; Re Canusa Holdings Ltd., *supra* note 220.

254 Re Midgaul Investment Ltd., *supra* note 216.

255 *E.g.* Re Webb, [1972] OSC Bull. 220 (October); Re Glandfield & Co. Ltd., *supra* note 240.

256 Re McNally, [1970] OSC Bull. 108 (July).

257 Re Forsythe, [1972] OSC Bull. 167 (August).

258 *E.g.* Re United Investment Services Ltd., *supra* note 251.

of a person from the securities business for a time coupled with the requirements that thereafter employment be in a nonsupervisory capacity. The courts have held in *Buck v. SEC*[259] that remedial penalties cannot be imposed as a deterrent and therefore the SEC must have evidence indicating that there is a possibility that the accused will commit further illegal or fraudulent acts before remedial penalties can be resorted to. It is not clear how substantial an impediment this is.

Apart from the use of remedial penalties, flexibility is also achieved by structuring remedial stipulations into offers of settlement accepted by the SEC. A form of restitution to the public is a not uncommon stipulation. Obligations can be imposed on clearing firms to make inquiries and take prompt steps to terminate any participation in activity which violates the securities laws. The SEC may limit the sanction to a particular branch office of a broker-dealer rather than to the entire firm, or prohibit only certain kinds of activity by the broker-dealer during a period of suspension, or only prohibit an individual from engaging in supervisory activities. In some cases, where a broker-dealer changes management and individuals associated with the infraction are barred by the SEC from association with a broker-dealer or investment adviser, a quite substantial infraction may be visited with a suspension only.[260] The OSC also employs remedial sanctions. The criminal process cannot, as yet, be used in this flexible manner.

There is one aspect of all this about which I feel uneasy. Settlements do, it is true, reflect a great deal of flexibility; it is possible that they could contain stipulations not directly authorized by the legislation. This imports a potential element of coercion against which there is no very obvious safeguard. It would be naive to assume that the SEC does not, in some measure, dictate the form of settlement which is submitted to it. Elbows are occasionally jogged by the SEC's regional office which may supply a form of settlement, approved in a previous case, in blank. It is true that a respondent can submit whatever form of settlement he or it desires. The respondent has the right to carry any offer of settlement up to the commission itself. It is reviewed regionally and at headquarters. Revisions may be suggested. A recommendation to accept or reject goes from the staff to the commission. Usually a respondent who is advised that the regional office or headquarters disapproves the settlement will withdraw it and rework the offer. There is much careful review before the settle-

259 413 F.2d 832 (6th Cir. 1969).
260 SEC, 38TH ANNUAL REPORT 70-71 (1972).

ment reaches the commission itself.[261] But the respondent's right to carry the matter forward if he wishes does not entirely dispel the aura of coercion which may be present. It would be impossible to do so, in any system which permits settlements.[262] The settlement is too useful a device to be eschewed entirely. It might be preferable to deal in the legislation with the matters which might form part of an administrative sanction or a settlement. Thus, for example, the legislation could deal explicitly with the temporary suspension of officers, their deprivation of emoluments, etc.; the discharge of guilty employees, and limit the terms of agreed settlements to variations on these approved themes. Section 1507 of the *ALI Federal Securities Code* affords a reasonably explicit drafting model, but it does not state what conditions may accompany a conditional suspension, or conditional bar from being an associate. The ALI is content to leave this area to further development; to leave the growth of restitution practices to evolution within a general form of words. I do not like this degree of latitude. A statutory power to carry offers of settlement to any regulatory commission which, as we have noted, reflects SEC practice, is, I submit, useful as a statement declaratory of the rights of the parties. Provision might also be made for ultimate judicial approval of the terms of any settlement and for ensuring its voluntary character.

There should be provision for appeal from any order made by any proposed commission in administrative proceedings. The commission should be under a duty to give reasons for its decision as the SEC now is.[263] Clause 9 of Ontario Bill 30 contains provisions which might well be taken as a model. It confers a right of appeal from a decision of the commission to the Supreme Court, save where the commission's decision is under clause 75 (an order exempting from registration of a prospectus). The secretary shall certify to the court the initial decision, the decision of the commission on review and the reasons therefor, the record of the proceedings before the commission, and all written submissions to the commission or other material that is relevant to the commission. The court may direct the commission to make such decision or do such other act as the commission is empowered to do under the act

261 I am indebted to the Seattle office of the SEC for much of this information

262 The obvious analogue is the practice of plea bargaining which is generally viewed with reservation in England, Canada and the Commonwealth; *see* the authorities collected and noted by the author in [1969] Ann. Survey Commonwealth L. 223; [1970] Ann. Survey Commonwealth L. 173-74; and J. Baldwin & J. McConville, Negotiated Justice (1977).

263 Beck v. SEC, 413 F.2d 832 (6th Cir. 1969).

or regulations and as the court considers proper. By subclause (6), a very useful provision:

> "(6) Notwithstanding an order of the court, on an appeal, the Commission may make any further decision upon new material or where there is a significant change in the circumstances, and every such decision is subject to this section."

Subclause (6) sets an intelligent and intelligible limit to the possible invocation of *res judicata*. The adoption of such a provision does not mean that a court would interfere readily with sentence. There would undoubtedly be a limiting principle, that the court would not intervene except in cases of gross error. As was said in *Armstrong, Jones & Co. v. SEC*:[264]

> "Unless a gross abuse of discretion on the part of the Commission is shown, the Commission's determination of the sanctions necessary to protect the public interest will not be disturbed."

There is a danger either that a regulatory body will become too severe, or, on the other hand, will relate too closely to the regulated industry and attempt to secure cooperation through leniency. Such policies may be adhered to even when it is inappropriate to do so. It would be useful to have an independent check via the Federal Court. The *ALI Federal Securities Code*, section 1514 makes provision for judicial review. It includes a power in the review court to permit the introduction of additional evidence. Nonetheless, section 1514(h) reflects the same bias as this proposal, stating,

> "(h) *Substantial evidence rule.* The findings of the Commission as to the facts, if supported by substantial evidence, are conclusive."

Under section 28(1) of the Canadian Federal Court Act (1970) a similar result would be produced; the Court of Appeal could determine on review whether the inferior court or tribunal's finding of fact was open on the material before it.[265]

E. STOP ORDERS

Stop orders may be used to stop trading in any security when it appears that an offering or distribution statement contains a

264 421 F.2d 359 (6th Cir. 1970); and *see* Berko v. SEC, 316 F.2d 137 (2d Cir. 1963).

265 *Per* Thurlow, J. in Re State of Wisconsin and Armstrong, 32 D.L.R. (3d) 265 (F.C.T. 1973); and R. DUSSAULT, 2 TRAITÉ DE DROIT ADMINISTRATIF, CANADIEN ET QUÉBECOIS 1321-23 (1974). *See also* the decision of the British Columbia Securities Commission in Re Ponderosa Industries Ltd., B.C. Corp. and Financial Services Comm'n Weekly Summary, September 12, 1975, at 1.

misrepresentation or omits a material fact or document required to be included. In the United States the SEC, under section 8(d) and 8(e) of the Securities Act of 1933, may issue a stop order suspending the effectiveness of any registration statement. The commission may make an examination in any case in order to determine whether such an order should issue. The commission or any officer or officers designated by it has access to, and may demand the production of, books and papers. It may administer oaths and affirmations to, and examine the issuer, underwriter or other person in respect of any matter relevant to the examination. There is also a general power of investigation under section 20(a) of the Securities Act of 1933. The *ALI Federal Securities Code* perpetuates the power to make stop orders in section 1506(d). It improves on the Securities Act by making it clear that a stop order must be expressly vacated by the commission in order to cease to have effect.

In Canada, most provincial acts also make provision for the use of stop orders. Clause 71(1) of Ontario Bill 30, which would amend the present act, would give the commission power to order that all primary distribution of securities to which a filed prospectus relates, shall cease. The usual provisions relating to hearings and temporary *ex parte* orders is made in subclause (2). Jurisdiction to make such an order depends upon the commission forming the view that any of the circumstances mentioned in clause 62(2) appear. These include: failure to comply with filing requirements, the presence of deceptive, false or misleading forecasts, concealment of material fact, the giving of unconscionable consideration for promotional services or property, and that the proceeds from sale of securities plus the other resources available to the company are insufficient to accomplish the purposes set out in the prospectus.[266]

The commission has interpreted its powers broadly. In particular it has issued a stop order when circumstances indicated that a company's operations deviated substantially from development plans specified in the prospectus,[267] or was acquiring very speculative securities not contemplated in the prospectus,[268] or was incurring large debts after having stated in the prospectus that no

266 The Commission has sought to maintain some control after promotion by requiring reports on the disbursement of funds as a condition of releasing shares from escrow; *see* for a recent example, Re Riley's Datashare Int'l Ltd., [1974] OSC Bull. 65 (March).

267 Re Kenilworth Mines, [1965] OSC Bull. 7 (July-August); Re Great Divide Explorations Ltd., [1965] OSC Bull. 10 (July-August).

268 Re Victoria Algoma Mineral Co. Ltd., [1966] OSC Bull. 5 (June).

indebtedness would be created or assumed.[269] It would now, however, seem more appropriate to deal with this problem by a general cease trading order of the sort discussed above. Such an order could also be used in the case of trading on the exchange if the exchange declined to act.

Chapter III
Investigations[270]

Securities regulation, like company law, bankruptcy law, and income tax law, is an area in which extensive investigative powers are conferred upon the government agencies active in regulating the field. There are a number of reasons for conferring investigative power. First and foremost unless facts relating to complicated cases of fraud are unearthed, the principals responsible for unlawful conduct may well be able to continue their illegal activities virtually unchecked. Securities fraud transactions are frequently complicated. Nominees are often used. The truth is difficult to ascertain. The fraud under investigation may continue or further frauds occur unless the full facts are uncovered. Somewhat the same considerations apply in respect of company law and bankruptcy law where fraudulent or incompetent directors may continue to mismanage companies unless and until sufficient information is found to put a stop to their conduct. In the case of the income tax acts there is the further consideration that the amount due to the state may only be discoverable as a result of investigative proceedings. In all of these areas the conferment of extensive investigative powers is commonplace.

Investigative powers, unless hedged about with special restrictions, can be used for enabling civil recovery of amounts obtained from the public as a result of fraudulent or improper schemes. They can be used as a means of obtaining facts necessary to warrant the imposition of administrative sanctions upon issuers, broker-dealers or both. Investigations can also be used as a means of acquiring facts which will later be employed against the persons under investigation in the criminal courts. Their significance should not be assessed from the number of recorded civil, criminal, and administrative proceedings which their use provokes. Informal dispositions may also owe much to their invocation. Thus, one seventh of all formal investigations closed informally by the SEC without formal disciplinary action during 1974

269 Re Medallion Mines Ltd., [1965] OSC Bull. 12 (September).

270 I am particularly indebted to the SEC and its Seattle office and to Messrs. J. Bookey

involved confessions of misconduct and offers of settlement including guarantees of good conduct during the future. In each of these cases the conduct was not thought serious enough to warrant formal disciplinary action. Other cases informally closed were remitted to state agencies. Some were closed for lack of evidence. There is no doubt that the investigation is one of the strongest weapons in the enforcement armoury.

The potentially onerous consequences of an investigation give rise to a concern that individuals' civil rights be protected. It is undoubtedly necessary that investigative schemes give wide jurisdiction and wide powers to the persons conducting the investigation. Undoubtedly there must also be some due process safeguards favouring individuals under investigation. This would remain true even if it were not possible to use the evidence obtained as the result of an investigation in a subsequent criminal case. The civil consequences of investigations can be extremely onerous. There is therefore a case for allowing certain basic safeguards such as the right to explain, the right to be informed of the case made by other witnesses in the inquiry and conceivably a right to counsel.

The case may be thought to be strong where criminal prosecution can follow an investigation, utilizing materials obtained as a result of the investigation, and the case becomes stronger still under statutes which permit whatever the person under investigation has said on oath to be used against him at a subsequent criminal trial. Indeed a tendency can be discerned to try to limit the use which can be made of materials ascertained as a result of investigations. Some statutes limit the use in evidence of matters related by an investigatee under oath. This is certainly true of section 114.3 of the Canada Corporations Act. It is not true of the Income Tax Act, nor is it true of such foreign legislation as the U.K. Companies Acts 1948–67. These matters are dealt with further in a later part of this paper.

The jurisdiction to examine persons and documents to be conferred upon the person conducting the investigation should be broad. It is undesirable to draft legislation with undue particularity since too much particularity, by inviting applications for judicial review based on want of jurisdiction, may prove inhibiting to investigations.[271]

The jurisdictional section employed by the *ALI Federal Securities Code*, section 1505(a), which does not differ materially from

and L. Emory for information. *See also* Merrifield, *Investigations by the Securities and Exchange Commission*, 32 Bus. Law. 1583 (1977).

271 There is in any event a general tendency to refuse interlocutory challenges to investigation procedures.

other U.S. enactments, simply provides that, "the Commission may investigate to determine whether any person has violated, is violating, or is about to violate this Code". The only limitation which this wording suggests is that a violation must at least be apprehended. Under section 1505(b), the so-called quasi-legislative provision, the commission may investigate to aid in the prescribing of rules or in obtaining information to serve as a basis for recommending further legislation.

The form of wording employed in Ontario Bill 30, clauses 11 and 13, which bears an affinity to the provisions of the Canada Corporations Act, 1970, is similar. Investigations could be commenced either by the commission under clause 11, or by the Minister under clause 13. The commission under clause 11(1) is empowered to commence an investigation where, upon a statement made under oath, it appears probable that any person or company has contravened the Securities Act or regulations or has committed an offence under the Criminal Code in connection with a trade in securities. This takes care of the case in which a violation is at least apprehended. In addition, however, the commission may, by clause 11(2), by order appoint any person to make such investigation as it deems expedient for the due administration of the act, or into any matter relating to a trade in securities and in such order shall determine and prescribe the scope of the investigation. This power is not expressed to require an allegation on oath or probable cause. Seemingly, subclause (2) is intended to permit investigations into trades and securities which do not necessarily disclose the infractions of the act, regulations or the Criminal Code but which appear to raise questions of general importance concerning securities trading.

This wide grant of power, including the power to conduct a public inquiry, appears to be desirable. The *ALI Federal Securities Code* in United States which builds upon the existing federal statutes in the field contains ample powers, as indeed do provincial acts in Canada, to require the attendance of witnesses and the production of books and papers once an investigation has been formally instituted. However, as will be seen, in many cases investigations are instituted informally and pursued for some time before it is decided to ask for formal powers. The reasons for this are the undesirability of harming companies, subjecting individuals to onerous consequences before it is clear that a real case for investigation exists and harming investors in general. This sort of preinvestigation or preliminary investigation technique is used not only by the SEC but by other regulatory agencies. We therefore think that an additional power in aid of investigation might be borrowed with advantage from the U.K. Companies Act 1967.

In an attempt to obtain a greater use of the investigation provisions in the Companies Act 1948 the United Kingdom Parliament enacted Section 109 of the Companies Act 1967 to enable the Department of Trade and Industry to obtain books and papers from companies without making a formal order of investigation with all the detriment to the company that might ensue. The section therefore allows the department to require the company, at such time and place as might be specified by the directions, to produce such books and papers as may be so specified or, if it thinks there is good reason to do so, to authorize any officer of theirs, on producing (if required to do so) evidence of his authority, to require any such body as aforesaid to produce to him forthwith any books or papers which the officer may specify. The power includes a power to take copies of or extracts from books and papers, to require a person in possession of them or employed by the body in possession of them, to provide an explanation of any of them, and if the books and papers are not produced to require the person who was required to produce them to state to the best of his knowledge and belief where they are. It is made an offence to fail to comply with any such requirement. This particular power is buttressed by section 110 which contains a power to enter and search premises with a warrant where there are reasonable grounds for suspecting that there are on any premises any books or papers of which production has been required by virtue of section 109 and which were not produced in compliance with that section.

The U.S. Law Institute draft would give power to require the production at any time of any of the records required to be kept by section 1503(b)(1) of that draft. It does not however seem to be a general preinvestigation power. The power in the Restrictive Trade Practices Commission acting under section 114(1) of the Canada Corporations Act 1970 is also not quite what is advocated herein. It does enable an investigation to begin without publicity. The hearings can be held *in camera* if necessary. It is not however an informal procedure of the sort contemplated here and it is unlikely that the news that a full inquiry is in progress could be kept confidential for long.

The need for preinvestigation powers corresponds to what appears to be the universal practice concerning complicated investigations of this character. Since the conferment of such powers in the United Kingdom, the Department of Trade and Industry reports a considerably greater use of investigative power than formerly.[272] In the United States, the SEC almost invariably be-

272 *See further* Fraser, *Administrative Powers of Investigation into Companies*, 34

gins investigations informally, in order to avoid prejudice to persons against whom no real evidence may ultimately be found.[273]

The manner in which SEC investigations are conducted is interesting. The source of suspicion may be a newspaper, a competing dealer, etc. The investigation may result from a market surveillance report showing unusual trading activity in a security. Investor complaints are another effective source. Stock exchanges, NASD, state and Canadian securities agencies are further such sources. So too are periodic inspections.[274] Very often the information is inconclusive.

A regional office (and investigations are conducted through regional offices) is often unable initially to take a view about the merits of a complaint and so proceeds informally. If the complaint appears to be substantial a file is opened. A computer search is undertaken for names. The computer printout gives details of the individual's involvement in the securities market. It is in fact a picture of his total involvement; it is not limited to disciplinary records and the like but includes filings, his status in other issues, and so on. The search often turns up much dross, but often much very useful information as well. The technique is said to be particularly useful where the existence of organized crime is suspected.

Once a file is opened, the regional office is committed to head office for the investigation. Headquarters and the regional office keep mirror files of proceedings. Sources of evidence are separately docketed. When an investigation is docketed the regional office takes charge. Quarterly reports are filed at headquarters. Cases are investigated by investigators and attorneys, often working as a team. Investigators report to the attorney who may advise them of further details to look for, issues to clarify and the like.

Subpoena powers where required are granted by the commission itself. These are sometimes not needed because broker-dealers are obliged by statute to have, and to make available, their records to the SEC at any time. The same observation applies to investment companies and to mutual funds. The *ALI Federal Securities Code* also, in section 1505(e) makes provision for subpoenas. Some entities such as banks and issuers can only be reached through subpoena.

The power to subpoena witnesses and documents is, in the United States as elsewhere, an incident for the formal process of

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Mod. L. Rev. 260 (1971); *see* Dept. of Trade and Industry, Companies in 1974, table II (U.K. 1974).

273 SEC, 37th Annual Report 103 (1971).

274 Ferrara, *SEC Division of Trading and Markets: Detection, Investigation and Enforcement of Selected Practices that Impair Investor Confidence in the Capital Markets*, 16 How. L.J. 950 (1971).

investigation. It is a power to administer oaths and affirmations, subpoena witnesses, compel their attendance, take evidence and require the production of books, papers or correspondence or other records relevant to the inquiry. The power may or may not include a power to freeze assets and control the affairs of the person under investigation.

Civil liberties problems arise in connection with investigations. The difficulty is that the investigation is seen as an inquisitorial rather than as an adversarial procedure.[275] The result is that even where investigatees are accompanied and advised by lawyers, they are not in general informed of what the investigators have discovered, nor are they given the right to attend and cross-examine other witnesses before the investigation. Professor L. Loss[276] notes that counsel may only advise his client on the question of self-incrimination and object to questions as outside the scope of the inquiry.

The direct protection given to investigatees also varies. In Canada under the Income Tax Act a person under investigation must answer upon oath, whether or not the answer would incriminate him, and the same appears to be true under the provincial securities acts. Under section 109(5) of the U.K. Companies Act 1967 a statement made by an investigatee pursuant to a demand from the Department of Trade and Industry may be used in evidence against him. Under section 114(3) of the Canada Corporations Act, answers given on an investigation may be accorded protection; if the investigatee claims protection, the answer may only be used against him in a subsequent proceeding for perjury stemming from the particular answer. In the United States, in order to procure answers to incriminating questions, an indemnity against prosecution must be offered the investigatee. Otherwise the constitutional protection against self-incrimination may be claimed.

But even the most favourable regime involves potential risk to the investigatee.[277] While an investigation may not of itself determine rights, it can certainly be gravely prejudicial. The resulting prejudice is often perfectly justified. A balance must be struck between the need for thorough and expeditious inquiries, and the interest of the individual in dispelling groundless suspicion arising from information or assertions at an early stage.

275 Re Pergamon Press Ltd., [1970] 3 All E.R. 535, 539 (C.A.) (*per* Lord Denning, M.R.); Norwest Holst Ltd. v. Dept. of Trade, [1978] 3 All E.R. 280.

276 3 L. Loss at 1954.

277 *See* Fuller, *Symposium on Federal Civil and Criminal Income Tax Fraud Investigations: Law and Order v. The Constitution*, 2 Hofstra L. Rev. 130, 134 (1974); Merrifield, *supra* note 270.

Some of the matters referred to can be instituted or remedied by administrative procedures if it seems desirable to do so. Others can only be dealt with by legislation. The discussion which follows is based upon issues disclosed in the theoretical writing, largely though not exclusively American, and from discussions with the SEC.

The first question raised in connection with current U.S. practice is whether there is sufficient control over the commencement of investigations. For our purposes the question becomes one of what controls ought to exist and how they should be administered. We should note that when head office action is required, for example when formal subpoena powers are sought, the regional office must justify the request and the commission review is substantial. Head office review of the case is thought by the region to be a useful device, very often effecting a clarification of the case. The commission reviews subpoena powers every six months to determine whether they should be kept alive. At some stage there will be a further review and a recommendation for injunction and/or administrative proceedings. The impression which I derived was of an agency which took pains to ascertain the merits of investigations before according extensive formal powers upon investigators.

It has, however, been argued that institutional review is patchy. The commission has powers to reject a request, ask for more information before making a decision or issue an order initiating an investigation. This process, while not objectionable in theory has become, it is alleged, a rubber stamp. Lowenfels asserts:[278]

> "If a staff member feels strongly enough to recommend an investigation, the Commission is inclined to concur. As a rule, the staff member who recommended the investigation is then given the power to try to prove his case. He becomes in effect a prosecuting attorney with great powers to examine the investigatee's files, issue subpoenas and depose witnesses. And he has the full power of the United States Government behind him."

There is no magic answer to this sort of problem. Institutional review procedures of a reasonable character exist in the SEC. It would be possible to vest review powers in the courts rather than the agency, thereby attaining a formal separation between the initiating and reviewing body. It is possible that a court, with less expertise than a commission, would conduct a less searching re-

278 Lowenfels, *Securities and Exchange Commission Investigations: The Need for Reform*, 45 St. John's L. Rev. 575 (1971).

view. If an application for review were publicized as a result of its being made in court or chambers, the investigatee might suffer avoidable prejudice. The functional separation of powers which now exists in the SEC would seem apt to minimize this sort of difficulty. I would suggest that powers to initiate investigations should be placed in a commission, with institutional review procedures specified by regulation. This would also conform to the pattern found in section 114 of the Canada Corporations Act. The commencement of investigations would not be subject to judicial review; some aspects of investigations procedure would however be so subject. Commencement would be subject to internal review and provision should be made, as in the United States, for periodical review by senior personnel of investigations in progress.

There have also been complaints that investigations are unduly prolonged, and that sometimes they become a general fishing expedition.[279] I did not derive this impression from the SEC. The SEC is aware that avoidable delay is bad for the investigatee because the financial community will not deal with a broker-dealer while he is under investigation. He is therefore in limbo. Accordingly, the SEC proceeds as expeditiously as possible.

In part, this problem can be dealt with by internal procedures. There seems no reason why unwarranted delay could not be dealt with also via judicial review. It might be advisable to consider whether, in any fasciculus of provisions dealing with investigations, we should not make provision for judicial review where the complaint is that the inquiry is not proceeding sufficiently expeditiously. I would certainly recommend that we do so.

It is not so easy to deal with the problem of the "fishing expedition". The jurisdiction section which I advocate is wide. Presumably, excess of jurisdiction would in any event continue to attract judicial review. But it would not be easy for a court to rule on the question whether the investigators were exceeding their jurisdiction. Unhappily, any narrower formulation could be put to an harassing purpose by investigatees. I would, therefore, with some reluctance, recommend against more restrictive conditions of jurisdiction. Accepting this recommendation entails the consequence that the practical utility of judicial review will be minimized.

We ought however, to consider whether there ought not to be an internal procedure for redress: that is, a section to which complaints of abuse of power might go, and which would be required to review the case with a view to determining whether complaints were justified. Such procedure could work more rapidly

279 *Id.*

than judicial review. The section's review procedure would not provide the complainant with an oral hearing. He would be apprised of the section's decision. It would entail undue delay if the section were obliged to give full reasons for its determination. A summary might however be provided either at the time of decision or later.

This suggestion differs from that of Lowenfels who suggests that each investigation should be assigned to a specific independent supervisor for his oversight. The supervisor could rule on whether information sought by the investigator should be disclosed, subpoenas issued, and the like. The proposal seeks to protect the investigatee by a separation of roles. The suggestion again is worth considering. It is not unlike an examining magistrate procedure. The supervisor is, one supposes, expected to stand neutral. It is labour-intensive in that the supervisor must keep abreast of the investigation at all times. It is not clear whether the supervisor's functions are to be decisional only or whether he is intended essentially to direct investigations. The former seems to be intended. It might be a time-consuming procedure since, at each stage when the investigator desires to take a significant step, the supervisor would have to review the file to determine whether it was justified, whether or not there had been any complaint. If the supervisor's caseload were heavy, there is a danger that either decisions would be delayed or review would become a purely formal process. The procedure would in my submission be too cumbersome to be worth adopting.

Other problems concern the conduct of the investigation itself. Investigatees are generally accorded the right to counsel while giving evidence before the investigator. Certainly this is so under section 114(13) of the Canada Corporations Act and clause 11(5) of Ontario Bill 30. Investigations are potentially so prejudicial that such rights must continue to be given.

Should investigatees have the power to object to the issue by the investigator of a summons to a third party, or to cross-examine other witnesses before the inquiry? I would return a negative answer to both. As to the former, it is the investigator's duty to obtain the fullest possible information. He therefore should have considerable latitude. Complaints of harassment and abuse of power could be dealt with by the review section, the creation of which is advocated herein. The general right of cross-examination is a feature of tribunals of inquiry, but, generally, not of administrative investigations where speed is required if civil or criminal proceedings are to follow. Furthermore, there will be a later stage, if prejudicial matter is discovered, at which the investigatee can make his defence. This affords some justification for restricting

the investigatee's participation. Tribunals of inquiry on the other hand are not always followed by judicial proceedings and no legal forum for dispelling prejudice which arises from them exists. There is therefore a very strong case for full participation by persons likely to be affected by the findings.[280]

Should the investigatee have power to refute the investigator's findings before these are formally submitted to the commission in any case where prejudicial action may be taken upon them? Again, the interests of speed and the consideration that another forum for defence will be provided militate against reopening the inquiry to enable a detailed refutation to be made. However, there is, I think, much more to be said for instituting a procedure whereby the investigatee will be furnished with a draft report and afforded an opportunity to comment on it before it goes forward. A limited provision of this sort appears in section 1505(d)(2) of the U.S. *ALI Federal Securities Code*, but only where the person under investigation may be the subject of adverse publicity. This is too narrow. Both the report and the investigatee's comments should go to the commission for review and action. In the event that the commission feels that the investigatee had raised a point of substance with which the investigator has not dealt adequately, the matter can be remitted back for further investigation.

Should we provide for a privilege against self-incrimination and if so in a modified or absolute form? If a full privilege is accorded it will be necessary to guarantee immunity from prosecution to witnesses before the inquiry if incriminating answers are to be obtained. The SEC made the point to me that the problem with granting such immunities to witnesses or providing that the witness' testimony shall not be used against him criminally is that it is often difficult to know who will eventually be a prime target. One might unwittingly grant immunity to a person who later is discovered to be a prime malefactor. It would in any event seem possible to elicit the truth without frequent recourse to the practice.

The real choice is between providing that where a witness claims a privilege against an incriminating question such answer shall not be used against him criminally save on a prosecution for perjury, and, on the other hand, compelling answers to such questions by statute, the answers to be capable of use in later criminal proceedings. Two questions at least are raised by these points. The first relates to fairness; what safeguards should witnesses have and why? The second, related question, is what purpose do we wish the inquiry to serve? Is it exclusively intended for administrative

280 Lord Salmon, Tribunals of Inquiry 14 (1967).

and civil uses, or is it used and intended to be used as an aid to criminal discovery?

I assume for the moment that investigations can properly serve both administrative and criminal discovery functions. I admit to a bias in favour of compelling answers by statute. The investigatee is entitled to be dealt with decently and expeditiously and he should certainly have the opportunity of dispelling any erroneous inferences which arise from his evidence. The same is true of other witnesses. The milieu is not that of a police station in which an ingenue is faced with a menacing and unfamiliar situation, often without benefit of counsel. He is certainly not entitled to be shielded from the consequences of his own wrongdoing and the prosecution should be entitled to use any weapons which come fairly into their hand.

In fact, however, I doubt whether it will make much practical difference which alternative is chosen. In the United States the invocation of the privilege against self-incrimination is thought often to be of little use, and an individual such as a broker-dealer who asserts the privilege can suffer disastrous consequences to his business. In any event most broker-dealer cases can, it is said, be proven without the oral testimony of the principal respondents. Thus one recent work states,[281]

> "I do not know of a single case in which the assertion of the privilege had any of the salutary benefits that juridical philosophers talk about. I can think of a number of cases where the assertion of the privilege stimulated successful prosecution with devastating personal results. I therefore recommend to you that you reject this as an instrument of advocacy."

In Canada, even if the customary protection is accorded, the investigatee may still be prejudiced by discovery of facts as a result of his testimony, or the uncovering of further witnesses. In addition, seizure of records may disclose the existence of documents which will prove helpful in the event of a future prosecution. Witnesses whose answers incriminate others will have afforded a hostage on oath which the prosecution can use in proceedings against the other. It is in this respect that our procedure of partial protection in respect of incriminating answers could prove useful, and this advantage may appear even more pertinent if the case is not a broker-dealer case, but one having wider or other connotations. In effect the prosecution, or in civil proceedings the agency,

281 Gould, *Due Process and the Securities Laws*, in PLI, New Trends and Special Problems Under the Securities Laws 367 (A. Sommer chairman, H. Enberg ed. 1970).

will have available from a number of persons what amounts to depositions on oath. The agency will know who to call, and what they can prove, and the transcript of investigation should afford a serviceable club.

It will be obvious from the preceding remarks that I see investigations as a forum for discovering facts which will not only assist in providing information tending to the better regulation of the securities markets, but also as a device for obtaining information which will later be put to use in civil, criminal and administrative proceedings arising from the particular case. Investigative provisions under provincial securities enactments can certainly be so used. There is no doubt of the difficulties which beset the prosecution of securities and related cases under even the most favourable regime for the prosecution.

In the United States the propriety of all this has been questioned.[282] It is said, in connection with income tax investigations, to be unfair to issue an investigative summons to gather evidence for a criminal prosecution. The purpose of such summons is to garner information in order to assess civil tax liability. The SEC apparently takes the view that civil discovery should not be used in aid of criminal process. If a criminal matter is discovered, civil suit is sometimes not persisted in; instead criminal proceedings are initiated.

This "proper purpose" doctrine may or may not be accepted. It is certainly difficult to apply in practice. U.S. courts hold that an Internal Revenue Service summons may be issued in aid of an investigation if it is issued in good faith and prior to the commencement of a criminal prosecution. This formulation is seen as a way of protecting against the possibility that a recommendation for criminal prosecution may be purposely delayed in order to afford the Internal Revenue Service (IRS) the use of the summons power to obtain evidence for the prosecution. The requirement is difficult to police for, apparently, current court cases uniformly hold that a summons issued for the proper purpose of assessing civil tax liability will not be voided simply because the information obtained may also have been used as evidence for a future criminal prosecution. In cases where prosecution has not been launched at time of issue of the summons, it may be difficult to show improper purpose. The difficulties are compounded by a general intertwining of the civil and criminal aspects of an income tax investigation, and it is submitted that the same difficulty is likely to appear in securities fraud cases.[283]

282 *See* Fuller, *supra* note 277; and *see* Donaldson v. United States, 400 U.S. 517 (1971).

283 SEC v. United Brands Co., [1975-1976 Transfer Binder] CCH Fed. Sec. L. Rep. ¶95,357 (S.D.N.Y. 1975).

I doubt whether a "proper purpose" limitation is desirable under securities legislation, let alone the Income Tax Act. No single clear purpose appears from existing legislation which is general in terms. Nor, in any event, do I think that a "proper purpose" doctrine can be applied by the courts with consistent results. I would suggest that the interests of regulation be given primacy and that involves the use of investigation as both a civil and criminal discovery device.

Chapter IV
Supervision of Self-Regulatory Agencies

In the United States as in Canada enforcement agencies rely extensively on self-regulatory agencies to police the field. In the United States, the National Association of Securities Dealers (NASD) is the only recognized body. In Canada broker-dealer associations and the Investment Dealers Association of Canada (IDA) are active. In Ontario and other Canadian provinces the securities commissions have direct power to suspend, expel, or revoke the licences of principals and salesmen, whether or not they belong to a self-regulatory agency, and can direct that as a condition of continued registration they undertake such courses as the Canadian Securities Course. In the United States, the Securities and Exchange Commission (SEC) functions primarily as a review body in the case of NASD members. It has of course direct original jurisdiction over SEC-only (SECO) registrants.

The jurisdiction which a federal body should have and the terms on which it should have it depends upon several factors. Among these are the size of the agency, the number and qualifications of personnel whom it can deploy to deal with disciplinary matters and its geographical distribution. A further and vitally important factor relates to the self-regulatory bodies themselves: how many are there, how efficiently are they operated, how do they discharge their functions, and is it, ultimately, reasonable to rely upon them as primary enforcement agencies?

The following paragraphs contain a summary account of the SEC's powers in relation to self-regulatory bodies because it provides an example of a "review" structure over discipline and related matters in the industry. It should not be thought however that the SEC's functions are purely repressive. Under the Securities Reform Act of 1975, for example, the SEC is obliged to ensure that self-regulatory agencies provide a fair procedure for diciplinary action, the denial of membership, the barring of any individual from being associated with a member, and the prohibition or limitation of any person with respect to requested access of-

fered by the organization or any member thereof. Notice of any final action by an agency which prejudicially affects any person must be filed with the SEC, and the SEC may of its own motion review any disciplinary action by a self-regulatory agency. The SEC also has the power to determine the scope of self-regulatory activity. By new sections 6(b)(5) and 15A(b)(6) of the Securities Exchange Act of 1934 it may require the rules of such organization to be designed to prevent fraudulent and manipulative practices, to promote safeguards against unreasonable rates, and in general to protect investors and the public interest. It thus has a general monitoring function.[284]

In Canada the Ontario Securities Commission has by section 140 of the Ontario Securities Act wide powers over the stock exchanges including review powers on appeal, but a less impressive range of powers over the Ontario division of the Investment Dealers Association of Canada or the Broker-Dealers' Association of Ontario. The latter bodies are less significant in Canada than is the NASD in the United States.

The SEC has the responsibility of supervising self-regulatory organizations dealing with broker-dealers who are not members of exchanges. Only the NASD fulfills this role at present. The SEC has the power to oversee the NASD's rules and can disapprove them. It has the power to abrogate any NASD rule if necessary or appropriate in order to attain the purposes of the act. The SEC did so in one case noted in the *1972 Annual Report* on the basis that the NASD rule was *ultra vires* the enabling act.[285]

The SEC also has the power to inspect NASD activities. In 1972 it was pleased to record that it had been granted extra funds to enable it to do so. It examines, on a sample basis, members of self-regulatory bodies to determine if they are complying with the securities laws. It also can examine a member of a self-regulatory body directly and at the same time review the examination report and working paper of that body in order to determine whether its examination program is thorough and effective. In addition, and in practice, the commission also normally reviews in advance of publication general policy statements, directives, and interpretations proposed to be issued by the association's board of governors, pursuant to its powers to administer and interpret NASD rules.

The SEC conducts periodic inspections of NASD activity. In 1971, the NASD offices in Boston and New York were inspected and a review was taken of the New York district office's programs

284 For an account of the United States amendments *see* Securities Reform Act of 1975, CCH Fed. Sec. L. Rep. (1975) (extra edition, No. 589) which contains also a useful section of committee reports.

285 SEC, 38th Annual Report 54 (1972).

and procedures with respect to the monitoring of the financial and operating conditions of NASD member firms. The structure of examinations and investigations thus appears to be similar to that which obtains in the case of the national stock exchanges. The SEC is informed of all NASD disciplinary actions. The NASD may impose on a member sanctions of expulsion, suspension, fine or censure. Where the violator is an individual, his registration as a representative may be suspended or revoked, he may be suspended or barred from being associated with any member, and he may be fined or censured. The NASD has in the past imposed apart from expulsion, substantial fines upon some of its membership. Censure is rarely imposed alone.[286] It is usually a secondary penalty where a more severe penalty was also imposed.

The SEC has the power of review over disciplinary action by the NASD. The SEC must sustain NASD action unless it finds that the penalties imposed are excessive or oppressive in which case it must cancel or reduce them. In the past, the SEC has drawn attention to the fact that it can only reduce penalties. It has suggested that it ought in a proper case to have the power to increase them.[287] Upon an application for review by the SEC the penalty imposed by the NASD is automatically stayed pending SEC review unless the SEC otherwise orders after notice of opportunity for hearing. A federal agency should also have power to call in a file with a view to imposing heavier penalties, or to review self-regulatory agency procedures, or perhaps to require a self-regulatory agency to proceed to invoke disciplinary measures. The SEC possesses power to remove officers and directors of self-regulatory agencies for failure, *inter alia*, to enforce compliance with the statutes and regulations or rules of the society.[288]

In most cases, the SEC upholds NASD disciplinary action. Thus the *1972 Annual Report* notes that where NASD exams were leaked and used by a firm in preparing its trainees, the revocation or expulsion of the firm would not be judged excessive or oppressive unless the most extraordinary mitigating facts were shown.[289] In another case, noted in 1965, the SEC did reverse an NASD decision against a firm which failed to complete a stock purchase contract where the firm believed in good faith that the transaction was part of a manipulative and fraudulent scheme. This was held by the SEC not to be unethical or dishonour-

286 SEC, 36TH ANNUAL REPORT 123 (1970).
287 SEC, 33D ANNUAL REPORT 88-89 (1967).
288 Securities Exchange Act of 1934, s. 19(h)(4), *as amended by* Securities Reform Act of 1975.
289 SEC, 38TH ANNUAL REPORT 56 (1972).

able.[290] The SEC concluded that under these circumstances the firm's action does not violate an NASD rule requiring the observance of high standards of commercial honour and just and equitable principles of trade. But the refusal to settle was only justifiable because the firm involved acted in good faith and fearing that the person with whom it was dealing was attempting to manipulate the market.

In each year there are a number of cases in which either NASD action is set aside or the penalties imposed by the NASD are reduced. In most cases, however, the NASD action is sustained and in general there is a tradition of supporting NASD disciplinary action. Attempts by the NASD in particular to devise and enforce a duty on employers to supervise employees have thus been loyally and effectively seconded by the SEC. This is precisely the pattern which one would expect to find.

The SEC also has jurisdiction over some aspects of NASD membership. Under section 15A(b)(4) of the Securities Exchange Act of 1934 and the NASD by-laws, no broker-dealer may be admitted to or continue in NASD membership without SEC approval if he has been suspended or expelled from membership in the NASD or a national securities exchange, if he is barred or suspended from association with a broker or dealer, member of the NASD or an exchange; his registration as a broker-dealer has been denied, suspended or revoked; he has been found to be a cause of certain sanctions imposed upon a broker-dealer by the SEC, NASD or an exchange; or he has associated with him any person subject to one of the above disqualifications. Any of these findings thus act as a prospective civil disability measure.[291]

The SEC has power under section 15(b)(4) of the Securities Exchange Act of 1934 to approve or direct admission to or continuance in NASD membership notwithstanding that the person is disqualified from membership under that section or under an effective NASD rule adopted under that section or under section 15A(b)(3). The procedure is for the member or applicant to initiate the matter. The NASD may then, at its discretion, file an application on behalf of the applicant with the SEC. If the NASD refuses to sponsor an application, the applicant may apply directly to the SEC for an order directing the NASD to admit or continue him in membership. In any event, the final decision is that of the SEC as ultimate guardian of the integrity of the markets. In one case noted in the *1963 Annual Report* an application from a firm for continuation of membership was denied where the firm intended

290 SEC, 31ST ANNUAL REPORT 72 (1965).
291 SEC, 34TH ANNUAL REPORT 97 (1968).

to admit as an employee the father of a principal in the firm who it was difficult to believe would be effectively supervised.[292]

Ontario has initiated follow-up procedures to ensure that complaints from the public regarding members of self-regulatory bodies are dealt with. This procedure is worth emulating.

Chapter V
Cooperation with Other Securities Agencies

For several years there has been an emphasis upon cooperation among the various regulatory agencies. This development is noted in detail in the *SEC Annual Reports*. Cooperation takes a number of forms. One is a comprehensive exchange of information concerning mutual enforcement problems and possible securities violations. Information is exchanged with foreign agencies.[293] Indeed, there is a considerable record of cooperation with Canadian securities administrators.[294]

The SEC refers some matters to state and local authorities for action where a matter appears to be confined largely to one state or local area and it appears that the matter will be dealt with promptly and effectively there. Examples might be a prosecution or proceedings for an injunction. The SEC frequently provides manpower assistance to state authorities in the development of securities cases.[295] The provision of assistance to United States attorneys has already been noted. State authorities are notified of important investigations being carried on in their state.

SEC regional offices have taken steps to improve the coordination of inspections and other activities with state securities administrators and with the NASD in areas where their respective jurisdictions overlap. The SEC and state authorities have conducted joint inspections, a practice which has made the entire inspection program more effective.[296]

The SEC has initiated a program of cooperative regional enforcement conferences at its regional offices. Its personnel meet with personnel from state securities agencies, post office inspectors, federal, state and local prosecutors and local representatives of self-regulatory agencies. In 1972 one session was opened to

292 SEC, 29TH ANNUAL REPORT 70 (1963).

293 Thus Belgium, as a result of material supplied by the SEC, declined to allow Investors Overseas Services (IOS) to trade there; *see* C. RAW, B. PAGE & C. HODGSON, *supra* note 60, at 272.

294 *See e.g.* SEC, 35TH ANNUAL REPORT 122 (1969); SEC, 34TH ANNUAL REPORT (1968) also contains an account.

295 For a full account, *see* SEC, 37TH ANNUAL REPORT 133 (1971).

296 *Id.* SEC, 36TH ANNUAL REPORT 126 (1970).

representatives from the industry with beneficial results. The conferences are designed,[297]

> "[T]o promote the exchange of information concerning regional enforcement problems, the development of methods of increasing cooperation and communication, and the elimination of needless effort and waste of manpower and other resources in the regulation of the securities market."

This is a step which we could emulate.

The SEC also holds an annual enforcement training program. It is attended by SEC personnel, persons from other federal and state agencies, and from other countries. In 1972, seven Canadian representatives attended. The *1972 Annual Report* notes,[298]

> "The program seeks to impart an understanding of how the securities markets operate, explain applicable rules, suggest desirable investigative procedures, indicate how available enforcement remedies can best be utilized and provide guidance in connection with the trial of securities cases."

I assume that this is a facility which we will ultimately emulate and of which we could in the interim take full advantage.

Chapter VI
Intelligence

A. STORING AND EXCHANGE OF INFORMATION

The SEC maintains a Securities Violation Section for storing and exchange of information. In acquiring information it is assisted by state and Canadian agencies. The section acts as a clearing house for information regarding enforcement action in securities matters taken by state and Canadian authorities, by other governmental and self-regulatory agencies and by the SEC. In 1969 for example information was received from several states and Canada on 104 criminal actions, 49 injunction actions, 169 cease and desist orders and 104 other administrative orders such as denials, supervisions and revocations of registration of issuers, broker-dealers and salesmen. It also received information from the U.S. Department of Agriculture concerning administrative action taken against future commission merchants and floor brokers under the Commodity Exchanges Act.[299] The data in the section files consti-

297 SEC, 36TH ANNUAL REPORT 127 (1970).
298 SEC, 38TH ANNUAL REPORT 89 (1972).
299 *See* SEC, 35TH ANNUAL REPORT 90 (1969).

tutes a valuable tool for screening applicants for registration as securities or commodities brokers or dealers, as well as applicants for loans from certain agencies.

The SEC publishes a periodical bulletin which is sent to contributing agencies and other enforcement and regulatory agencies. The bulletin contains current information which is a matter of public record regarding the institution and disposition of remedial and enforcement proceedings including proceedings initiated by the NASD.[300]

Other bodies have pertinent information. The OSC, for example, contacts Interpol for data on the criminal record, if any, of persons seeking registration as broker-dealers or salesmen.[301] The OSC has, it may be noted, informed all registrants under the Securities Act that violation of the securities laws of any jurisdiction is prejudicial to the public interest and affects fitness for continued registration in Ontario.[302]

The material in the Securities Violations Section files goes beyond criminal convictions and proven securities violations. In addition, as we have noted, the SEC has a data bank index of the names of persons who have been named in formal filings with the SEC, have been a party to a proceeding, or have been involved in an investigation.[303] Computer name searches are run on prospective securities salesmen and others whose names are submitted by the stock exchanges, NASD and state securities commissions.[304]

In addition, the SEC maintains and publicizes a Foreign Restricted list which comprises the names of foreign companies whose securities the SEC has reason to believe recently have been, or currently are, being offered in the United States in violation of the registration requirements of the Securities Act. Broker-dealers will not, in general, touch such companies, but promoters illegally offer such securities directly to investors in the United States, either personally or by mail. Originally the list was known as the Canadian restricted list. It is a matter of satisfaction to note that Canadian companies are much less prominently featured in it today.

300 SEC, 29TH ANNUAL REPORT 133 (1963).

301 Re Thomas, [1972] OSC Bull. 118 (June). Interpol does not, however, concern itself in practice with so-called "economic crimes". *See* Feraud & Schlanitz, *La coopération policière internationale*, [1976] REVUE INTERNATIONALE DE DROIT PÉNAL 475-98.

302 [1968] OSC Bull. 17 (February).

303 SEC, 36TH ANNUAL REPORT 94-95 (1970).

304 SEC, 33D ANNUAL REPORT 74 (1967).

B. MARKET SURVEILLANCE[305]

The SEC conducts a market surveillance program to identify possible manipulative activities. This is coordinated with the stock-watching operations of the New York, American and regional exchanges. The staff maintains a continuous ticker tape watch of transactions on the New York and American Stock Exchanges and monitors the sales and quotation sheets of regional exchanges in order to detect any unusual or unexplained price variations on market activity. If any of these sources reveals possible violations the market surveillance staff conducts a preliminary inquiry into the matter. The inquiry generally begins with the identification of brokerage firms which were active in the security. The staff may communicate with principals or registered representatives of these firms, with customers, or with officials of the issuer involved to determine the reasons for the activity or price change in the securities in question and whether violations have occurred. The Ontario Securities Commission relies not on its own monitors, but upon close liaison with the Toronto Stock Exchange. This cooperation has obviously proved fruitful.

The SEC has also developed an over-the-counter surveillance program involving the use of automated equipment to provide more efficient and comprehensive surveillance of stock quotations distributed by the National Quotation Bureau and the NASD's automated NASDAQ service. Automated equipment is programed to identify, among other things, unlisted securities whose price movement or dealer interest varies beyond specified limits in a preestablished time period. This data, combined with other available information, is collated and analyzed to select those securities whose activity indicates the need for further inquiry or referral to the commission's enforcement staff.

The market surveillance branch considers that it has primary responsibility for surveillance in the over-the-counter market, as it maintains the only automated surveillance program.

C. INVESTOR COMPLAINTS

Investor complaints are another effective tool. In 1971 there were 17,000 complaints from the public against broker-dealers. These are carefully analyzed by a special staff unit within the Division of Trading and Markets. In 1971, approximately 80% of

305 SEC, 37TH ANNUAL REPORT 102 (1971); contains a full account; *see also* Ferrara, *supra* note 274.

complaints involved back office problems such as the failure of firms to deliver securities or funds promptly and the alleged improper handling of accounts. The SEC cannot arbitrate in private disputes, but a complaint may lead to a referral as described below.

If it becomes apparent from SEC scrutiny that there has been a violation of the securities laws the complainant is referred to the appropriate enforcement officials at the SEC. The SEC may in turn refer the subject matter of the complaint to the appropriate stock exchange if a listed security is involved, or to the NASD if the security is traded over-the-counter, to enable the self-regulating agencies to take internal administrative action. Ferrara concludes:[306]

> "Thus, it may be seen that analysis of investor or consumer complaints may be used as a vehicle for not only detecting problems that affect capital markets generally, but also providing information as to houses experiencing particularized (*sic*) problems."

A recent noteworthy development is the SEC proposal to establish a clearing system for information on lost, stolen and counterfeit securities. Securities firms, exchanges and dealers will have, if the proposal is accepted, to report missing, stolen or counterfeit securities. They will also have to notify the SEC in case of recovery of any such securities. This follows a rule adopted in 1974 requiring all persons handling securities to be fingerprinted.[307]

A further technique, worth emulating, is the systematic use of publicity to alert the public to the dangers of fraudulent schemes. This typically includes information concerning the type of fraud concerned and the methods employed.[308]

Chapter VII
Organized Crime

In 1969 and 1970 the SEC indicated that it was taking special steps to deal with the problem of organized crime. Close liaison

306 Ferrara, *supra* note 274, at 961.

307 *See SEC Proposes System to Amass Information on Stolen Securities*, The Wall Street Journal, January 22, 1976; Rowen, *Securities Acts Amendments of 1975*, 8 Rev. Sec. Reg. 889 (1975).

308 Fraudulent Practices in Connection with Oil and Gas Fractional Interests, SEC, Securities Exchange Act of 1934 Release No. 11992, January 8, 1976 [1975-1976 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 80,355.

with the U.S. Department of Justice was announced, with staff members placed in strike forces. The *Annual Report* announced:[309]

> "This unit acts as a 'backup' unit to the various strike forces and is an enforcement unit investigating certain securities violations in which persons with organized crime associations are believed to be involved."

Organized crime is thought to complicate matters by threatening witnesses, destroying documents, using nominees and foreign bank accounts, and working through foreign affiliates. The SEC in 1972 noted that nonetheless, enforcement agencies had had some notable successes. No doubt the RCMP and others will wish to consider whether a federal agency should seek an involvement in this area, and, if so, what form it might take. The question of foreign involvement, treaties of assistance and the like, falls outside this paper.

309 SEC, 36TH ANNUAL REPORT 123 (1970).

Insider Trading

Marvin Yontef

May 1978

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Chapter I
Introduction

Company law and securities regulation statutes in Canada[1] deal extensively with insider trading which "is generally used to denote purchases or sales of securities of a company effected by or on behalf of a person whose relationship is such that he is likely to have access to relevant material information concerning the company not known to the general public".[2] The legislation is based on the generally held view that "[while] it is not improper for an insider to buy or sell securities in his own company...it is improper for an insider to use confidential information acquired by him by virtue of his position as an insider to make profits by trading in the securities of his company".[3] This view from the *Kimber Report* was

This paper was completed in the fall of 1977 and early winter of 1978, with the result that the information provided herein is primarily as of fall, 1977. As it is difficult for a practising lawyer to keep apprised of developments in the many jurisdictions referred to herein, the writer expresses his gratitude for the time permitted for even this limited coverage by the firm with which he was associated when the paper was undertaken and the firm of which he is now a member. Of the many who assisted in searching out materials and preparing drafts and footnotes, a special debt is owed to Carolyn Rosenstein who typed many "final" drafts. The usual disclaimer for the personal views expressed and responsibility for errors applies.

1 *See e.g.* Canada Business Corporations Act; British Columbia Securities Act; British Columbia Companies Act, S.B.C. 1973, c. 18, *as amended*; Ontario Securities Act.

2 KIMBER REPORT ¶ 2.01.

3 *Id.* ¶ 2.02. This is not, however, a unanimously held view. *See-e.g. contra* H. MANNE,

the impetus for legislative controls in Ontario in 1966[4] and thereafter in most Canadian jurisdictions.[5]

The legislative controls over insider trading in Canada, both in the provinces and federally, are virtually identical in principle. Insiders are required to report on their ownership of and transactions in securities of their companies. Liabilities may be imposed upon insiders when they have made use of confidential information for their own benefit or advantage. While there are slight variations of detail in the legislation, no Canadian jurisdiction has departed significantly from this legislative approach.

The purposes of this paper are fourfold. The first is to describe and analyze Canadian legislation on insider trading. The second is to compare the Canadian regulatory positions with those of selected foreign jurisdictions. The third is to consider the legal issues raised by insider trading and to evaluate the legislation to control it. The fourth is to explore improvements to the current regulatory system. The overall question to be considered is the role for federal regulation on insider trading.

Recently, legislators have joined the commentators in Canada[6] who have written on the subject of insider trading by recom-

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INSIDER TRADING AND THE STOCK MARKET, ch. 1 (1966) where the author discusses the basis for regulation of insider trading.

4 Ontario Securities Act, pt. XI [hereinafter cited as the Ontario Act].

5 At present, all jurisdictions in Canada regulate insider trading by statute except New Brunswick, Nova Scotia, Prince Edward Island, Newfoundland and the Northwest and Yukon Territories. For more detailed legislative background in this area, *see, Anisman* at 173.

6 On the subject of insider trading generally, *see* J. WILLIAMSON, SUPP. at 351; F. IACOBUCCI, M. PILKINGTON, J. PRITCHARD, CANADIAN BUSINESS CORPORATIONS 341 (1977); D. JOHNSTON at 275; P. ANISMAN at 115, *Anisman* 151; Cranston, Comment, [1974] U. TORONTO FAC. L. REV. 175; Crawford *Insider Trading*, 8 CAN. B.J. 400 (1965); Creber, *Takeover Bids, Insider Trading and Proxy Requirements*, in LAW SOCIETY OF UPPER CANADA, SPECIAL LECTURES: DEVELOPMENTS IN COMPANY LAW 235 (1968); Davies, *Canadian and American Attitudes on Insider Trading*, 25 U. TORONTO L.J. 215 (1975); Downs, *Bill 125 and Insider Trading*, 9 WESTERN ONT. L. REV. 91 (1970); Hretzay, *Market Morality: A Developmental Analysis of Insider Trading Legislation in Manitoba*, 6 MAN. L.J. 257 (1975); Johnston, *Insider Trading Liability; A Comparison of U.S. and Ontario Legislation*, [1968] OSC Bull. 199 (September); Johnston, Comment, 51 CAN. B. REV. 676 (1973); Johnston, Comment, 2 CAN. BUS. L.J. 234 (1977); Johnston, *Insider Trading Liability Legislation - Green v. Charterhouse Group Canada Ltd.*, 15 WESTERN ONT. L. REV. 239 (1977); Kimber, *A Second Look at Insider Trading*, in ISAAC PITBLADO LECTURES, THE LAW CATCHES UP: RECENT LEGISLATIVE CHANGES 89 (1969); Lewtas, *Directors', Officers and Insiders' Liability*, in LAW SOCIETY OF UPPER CANADA, SPECIAL LECTURES: CORPORATE AND SECURITIES LAW 183 (1972); Magnusson, *Insider Trading: The Basis of Liability* 1 QUEEN'S L.J. 53 (1968); Mullin, *Insider Transactions*, in ISAAC PITBLADO LECTURES, COMPANY LAW 235 (1965); Pryde, *Canada Corporations Act and Insider Trading*, 12 CAN. B.J. 125 (1969); Rothman, *Insider Trading, Proxy Solicitation and Takeover Bids under the Canada Corporations Act*, 17 MCGILL L.J. 521 (1971); Williamson, *Takeover Bids and Insider Trading*, 28 BUS. Q. 47; Wortsman, *The Insider: A Survey in Corporate Disclosure*, 25 U. TORONTO FAC. L. REV. 55 (1967).

mending and adopting changes in the law. Proposals and new laws which significantly expand liabilities for insider trading contribute to making comment in this area difficult. The Canada Business Corporations Act (hereinafter the CBCA),[7] which applies to newly incorporated federal companies and existing federal companies which have elected to continue thereunder,[8] contains markedly different controls than does the Canada Corporations Act (hereinafter the Canada Act).[9] Similarly, recent attempts to amend securities legislation in Ontario[10] have suggested departures from existing provisions. As a result, the comments herein are directed at existing legislation but they will also assume that proposals for change will eventually appear in legislation, substantially in the same form as published to date.

Chapter II
Insider Reporting

A. INTRODUCTION

There are several reasons for imposing a reporting obligation upon insiders of a company. An insider's report may serve as evidence for purposes of subsequent legal proceedings in that a regulatory body or a party seeking to impose insider trading liabilities will have access to the reports of an insider's transactions. The fact that an insider must report and the act of reporting itself may have salutary effects since the insider discloses and publicizes his trades in the company's securities.[11] Public reporting furnishes the market with the insider's assessment of his company's securities and the information in those reports may affect the market's evaluation of the securities.[12] Insider report-

7 Canada Business Corporations Act [hereinafter cited as CBCA].

8 *Id.* ss. 3, 261.

9 *Compare* pt. X of the CBCA *with* ss. 100-100.6 of the Canada Corporations Act [hereinafter cited as the Canada Act].

10 *See* particularly Ontario Bill 30, pt. XX, for proposed regulation of "Insider Trading and Self-Dealing" and pt. XXII relating to "Civil Liability"; *see also* Bray, *Ontario's Proposed Securities Act: An Overview, Its Purpose and Policy Premises*, [1975] OSC Bull. 235 (October); Dey, *Securities Reform in Ontario: The Securities Act, 1975*, 1 CAN. BUS. L.J. 20 (1975).

11 1 BUSINESS CORPORATIONS PROPOSALS ¶¶ 254, 256; *see also* L. BRANDEIS, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT 62 (R. Abrams ed. 1967), *quoted in*, *Anisman* at 181 n. 188.

12 *See* in this regard [1967] OSC Bull. 9 (June) from which the following observation appears:

> "Clearly the purpose of the legislation is to bring to the attention of the public the view that those in a position to know most about a company's affairs take of the company's shares at the particular prices at which they are trading."

ing, therefore, constitutes the material disclosure for purposes of potential liability but it may have greater impact by virtue of its effects on the insider and others in the market.

Notwithstanding that insider reporting is meant to perform these several independent functions, it has neither been as fashionable an area for comment as the insider liabilities issue, nor has there been a great deal of consideration of the reporting issues *per se*.[13] There are several significant questions raised by the legislative provisions imposing insider reporting obligations and, in view of the dearth of reported cases on insider trading liabilities and the considerations generally in bringing insider trading actions which are outlined below, the reporting obligations may be seen to constitute the only substantive regulation of insider trading in Canada. It is, therefore, critical that the reporting obligations be responsive to the purposes for which they are imposed.

B. COMPANIES IN WHICH REPORTING OBLIGATION IMPOSED

Insider reporting applies in companies whose securities are widely held. The Securities Act of each of the "uniform act provinces"[14] imposes obligations on insiders of a company which has voting securities outstanding in respect of which a prospectus or document of similar import has been filed with the provincial securities commission.[15] The Quebec Securities Act, the Canada Act and the Ontario Bill 30 base their application on whether *any* securities are outstanding in respect of which a prospectus or document of similar import has been filed with the applicable regulatory body.[16] The CBCA refers to any securities outstanding from a "distribution to the public".[17] Therefore, the concept of widely-held securities as it relates to insider reporting varies in that, in the uniform act provinces, application of the statutes results from a theory of widely-held equity securities whereas the remaining jurisdictions base application of the legislation on a concept of widely-held securities of any type.

Insiders of a company which has shares listed or posted for trading on a stock exchange are subjected to insider reporting

13 Indeed, note that Bray, *supra* note 10, does not mention insider reporting as an issue of sufficient import to require significant reform in the first major revision of securities regulation in Ontario in over 10 years.

14 "Uniform act provinces" refers to Ontario, Manitoba, Saskatchewan, Alberta and British Columbia.

15 *See e.g.* Ontario Act, s. 109(1)(b) and note specific reference to date of filing the prospectus; *but see also* Ontario Bill 30, s. 1(1)(36), where a broader class of companies would be involved under the definition of "reporting issuer".

16 *See e.g.* Canada Act, s. 100(1).

17 CBCA, s. 121(1); *see* definition of "distributing corporation".

obligations. In the uniform act provinces and Québec, the exchange must be one recognized by the local securities commission.[18] In the Canada Act,[19] listing on any stock exchange in Canada gives rise to insider reporting obligations. Application of the reporting obligation by virtue of listing on a stock exchange is another way of demonstrating a concern with widely-held companies so that, for example, an exchange listing of non-voting securities in one of the uniform act provinces will give rise to reporting requirements notwithstanding that there has been no distribution of equity shares.[20]

Insiders of relatively widely-held companies may not be subject to insider reporting obligations. Provincially incorporated companies which have not distributed equity shares publicly and do not have a class of securities listed on a stock exchange do not involve their insiders in reporting obligations. Insiders of any foreign company whose securities are widely held but which were neither distributed pursuant to a prospectus as contemplated by the statutes nor listed on a Canadian stock exchange are exempt.[21] Companies which have issued what are ultimately widely-held exempt securities, such as short-term promissory notes, will not occasion reporting obligations for their insiders.[22] Canadian regulation envisages either an initial distribution to the public or a continuing stock exchange listing which, while applying to most widely-held companies, does not cover all.

It may be noted that securities regulation statutes and corporations law containing insider reporting obligations are somewhat different in application. Corporations statutes such as the Canada Act and the Ontario Business Corporations Act apply to companies incorporated under those statutes.[23] Securities regulation statutes apply irrespective of jurisdiction of incorporation and contain exemptions if reporting is made under the province's corporations law.[24] In practice, securities commissions are respon-

18 *See e.g.* materials in note 15 *supra*.

19 Canada Act, s. 100(1), "public company".

20 This is a material consideration in Canada where a significant number of issuers have participating preferred shares listed on an exchange while the common (voting or "equity") shares are closely-held. Another consideration is the "posting" for trading whereby an exchange, without receiving application for listing, may "post" securities, which are widely traded locally, on the exchange for trading.

21 Since few widely traded U.S. companies are "posted" for trading on Canadian exchanges, Canadian holders of U.S. securities receive no insider reporting protections from Canadian securities laws.

22 Debt obligations of, for example, Canadian affiliates of foreign banks in Canada are universally "exempt". The fact that these securities are widely held does not give rise to inside reporting.

23 Canada Act, s. 2; Ontario Business Corporations Act, s. 2.

24 *See e.g.* Ontario Act, ss. 109(b), 101(a)(iii). Note also that Canadian chartered banks are not "corporations" giving rise to insider reporting.

sible for all provincial insider reporting and the federal corporations branch administers insider reporting as part of its duties under the general corporations law.

By way of comparison, United States federal regulation imposing insider reporting obligations shares the same concern of Canadian regulation in the application to widely-held companies. Under section 16(a) of The Securities Exchange Act of 1934 (hereinafter the 1934 Act),[25] reports are required from insiders of a company which has any class of its securities listed on a stock exchange *or* which has assets exceeding $1 million and 500 or more holders of a class of its equity securities.[26] The scope of companies to which insider reporting applies in these two jurisdictions may appear to be different but this is probably not the case. Companies embraced by a definition relating to assets and stockholders as a class should not be markedly different to those covered by definitions based on distributions to the public. In any case, listing on a stock exchange is covered similarly in both jurisdictions. Therefore, the United States example is not immediately helpful in offering directions for application.

The legislative provisions of Commonwealth countries do not distinguish between widely- and closely-held companies. In Britain,[27] Australia[28] and New Zealand[29] insiders of all companies are required to report. However, reporting is made to the company thereby reducing the impact of obligations imposed on insiders of closely-held companies. In the case of companies whose securities are listed on a stock exchange, the rules of the exchange impose additional obligations. For example, The [London] Stock Exchange requires reports upon application for listing and thereafter.[30] The Commonwealth examples show greater breadth of application to subject companies but it is doubtful whether reports to the company itself provide a better alternative for unlisted companies. Whether reports to an exchange in lieu of a securities

25 Securities Exchange Act of 1934 [hereinafter the 1934 Act].

26 *Id.* s. 12(g).

27 *See* Companies Act, 1967, U.K. 1967, c. 81, s. 2 (repeal of "exempt private company status"); *id.* ss. 27-29 (directors' duties to report); *id.* ss. 33-34 (reports from influential shareholders); *see also* REPORT OF THE COMPANY LAW COMMITTEE, Cmnd. No. 1749, at 88-91, 99, 141-47 (1962) (JENKINS REPORT); *see also* Companies Act, 1976, U.K. 1976, c. 69, amending the provisions.

28 *See e.g.* Companies Act, 1961, Victoria, Acts of Parliament, 10 Eliz. 2, No. 6839, *as amended*, ss. 69A-N (reporting by substantial shareholders); *id.* ss. 126-27 (reporting by directors); *see also* R. BAXT, H. FORT & G. SAMUEL, AN INTRODUCTION TO THE SECURITIES INDUSTRY ACTS (1977) for details of regulatory patterns.

29 *See generally*, Companies Act, New Zealand Stats., No. 63 (1955) *as amended*; FINAL REPORT OF THE SPECIAL COMMITTEE TO REVIEW THE COMPANIES ACT (New Zealand, March 1973) (MACARTHUR REPORT).

30 *See* THE STOCK EXCHANGE, ADMISSION OF SECURITIES TO LISTING, ¶ 2, ss. 4(c), 6(h), 9(e), 9(j) ("Listing Agreement").

commission are an improvement on the Canadian provisions is questionable.[31]

There has been a slight trend toward expanding the class of companies in which insiders must report in Canada.[32] At the same time, such refinements to the definitions do not appear to be material or, in any case, the subject for additional national regulation. In the absence of other than arbitrary standards to increase or decrease the number of companies involved in the present system, there is no apparent need for change.

C. DEFINITION OF INSIDER FOR REPORTING PURPOSES

Canadian statutes are relatively uniform in designating "insiders" for reporting purposes. Directors, officers, owners of or individuals or companies exercising control or direction over 10% or more of the equity shares are subjected to reporting obligations.[33] Affiliated companies, which are sister, subsidiary, sub-subsidiary and parent companies, are included in the definition of insider for reporting purposes.[34] An insider of a corporate insider of a company is deemed to be an insider of the company.[35] In corporations statutes which permit a company to buy its own shares, the company is an insider of itself.[36] The only major variation in the definition of insider for reporting purposes in Canada is contained in the British Columbia Securities Act.[37] In British Columbia, "associates", which include companies in which the insider has a 10% or greater equity interest, partners of an insider, trust or estates in which the insider has a substantial beneficial interest or in which the insider acts as trustee, the immediate family of the insider and relatives of the immediate family sharing the same residence are insiders.[38] The definitions of insider for reporting purposes are relatively clear and specific.[39]

31 An interesting contrast may be found in SECOND REPORT OF THE COMPANIES LAW REVISION COMMITTEE, COMPANY LAW 250-59 (Hong Kong, April 1973) where the concept of insider reporting is rejected for reasons, *inter alia*, of Chinese traditions of secrecy in business.

32 *See* Ontario Bill 30, s. 1(1)(36) (definition of "reporting issuer"). An example cited in D. JOHNSTON at 279, n. 16, is a debenture of a trust.

33 *See e.g.* Canada Act, s. 100(1) "insider".

34 *See e.g.* Canada Act, s. 100(2)(d). A subsidiary company would be deemed to own the securities held by its parent. *See also id.* ss. 100.1(7), (9).

35 *See e.g.* Canada Act, ss. 100(2)(a), (b), (c).

36 *See e.g.* CBCA, s. 121(1) "insider".

37 *See* British Columbia Securities Act, s. 106.

38 British Columbia Securities Act, s. 106(1)(c).

39 There is, however, no guidance on the meaning to be attributed to "direction" over equity securities. Presumably an insider need not have absolute control but the degree required for "direction" is uncertain. In the U.S., the SEC has equated "direction" with rights to direct voting, disposition of the securities, dividends or

In the United States, pursuant to section 16(a) of the 1934 Act, an insider for reporting purposes is substantially the same as in Canada. Directors, officers and 10% shareholders constitute the class of persons required to report. However, there are three important differences. The position of the Securities and Exchange Commission (SEC) has been that spouses and members of the insider's immediate family sharing his home are covered by the reporting requirements[40] and, with the exception of British Columbia, this requirement has not been the case in Canada. The 1934 Act does not extend reporting obligations to affiliates and insiders of insiders. There are exemptions from the reporting requirements for a number of transactions which would otherwise be reported in Canada such as, for example, small transactions, dealings of market-makers in securities and arbitrage transactions.[41] As will be discussed more fully below, the principles of identifying insiders for reporting purposes are similar but the differences are material.

In the Commonwealth countries, the definition of "insider" for reporting purposes is, again, substantially the same as in Canada.[42] Directors and substantial shareholders must file insider reports.[43] However, the basis for insider reporting is somewhat different. In Canada, insider reporting emanates from influence and access to confidential information.[44] The British position, which has been followed in the Commonwealth countries, has been described as follows:

> "[D]isclosure of holdings and dealings by directors has been regarded as necessary to prevent the abuse of insider information, whereas disclosure by other shareholders has been thought of as required mainly to protect direc-

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proceeds of sale; *see* SEC, Securities Exchange Act of 1934 Release No. 11,616, August 25, 1975, [1975-1976 Transfer Binder] CCH FED. SEC. L. REP. ¶ 80,285; *see also* CBCA, s. 228(2).

40 *See e.g.* SEC, Securities Exchange Act of 1934 Release No. 7793, January 19, 1966, 3 CCH FED. SEC. L. REP. ¶ 26,031-32 (securities held by family members).

41 *See* 17 C.F.R. ss. 240.16a-1-10 (1977) cited in 3 CCH FED. SEC. L. REP. ¶¶ 26,001-010; *see also* SEC, Securities Exchange Act of 1934 Release No. 21, October 1, 1934, 3 CCH FED. SEC. L. REP. ¶ 26,021-25; SEC, Securities Exchange Act of 1934 Release No. 116, March 9, 1935, 3 CCH FED. SEC. L. REP. ¶ 26,026-27; SEC, Securities Exchange Act of 1934 Release No. 1965, December 21, 1938, 3 CCH FED. SEC. L. REP. ¶ 26,041-50; SEC, Securities Exchange Act of 1934 Release No. 7824, February 14, 1966, 3 CCH FED. SEC. L. REP. ¶ 26,030; SEC, *supra* note 40.

42 *See* material in notes 27-30 *supra*.

43 An interesting comparison may be found in the Companies Act, 1967 U.K. 1967, c. 81, ss. 28, 30, 31, where interests of "associates" are deemed to be insider interests that must be reported.

44 *See* KIMBER REPORT, ch. 2.01.

> tors (and members and employees) against having their companies taken over without their knowledge."[45]

This position on reporting gives weight to the value of publicity in directors' dealings, as is the case in Canada, but also emphasizes the prevention of secretive acquisitions of control.

Canadian legislation has extremely broad application in its listing of the insiders required to report. The application to directors, officers and 10% shareholders involves a relatively straightforward determination of what is usually a small class. However, the provisions of the statutes which deem affiliates to be insiders, as well as those which require an insider of an insider to report, are onerous. In the example where the company is a subsidiary of a multinational corporation, the effect of such provisions is to impose worldwide corporate and personal obligations since directors and officers of remote sister companies must report. In Ontario, until recently, the obligation was imposed whether or not the insider owned any securities of the company since he had to file "Nil" reports. The position, rejected in Ontario, has found favour in British Columbia, Alberta, Québec and federally so that insiders must report even if they own no securities of the company.[46] Even if a remote insider does own securities in the "Canadian" company, the reporting obligation applies whether those securities will ever be traded in Canada or whether they are likely to be bought or sold in transactions with Canadians. While this extensive reporting obligation may be reduced by exemption orders and by the provisions of the statutes and regulations to permit abbreviated reporting[47] there is, by any measure, a substantial obligation. There is justifiable criticism on the basis of undue breadth of regulation with the corollary that such broad application may constitute an invitation to disregard legal obligations and to lenient administration of the provisions.

As much as the obligation to report is broadly based, it is also quite narrow. In Canadian jurisdictions, except for British Columbia, the ready avoidance of insider reporting obligations is exemplified by the insider who effects transactions for the account of his spouse or children. In all the Canadian jurisdictions at present,

45 L. Gower at 389.

46 Kimber Report ¶ 2.17 recommended "Nil" reports. As a result of criticism, the OSC rescinded this requirement in Ontario Securities Commission Policy No. 3-13, November 1, 1975, 2 CCH Can. Sec. L. Rep. ¶ 54,907; *see* CBCA, ss. 122(1)-(3) and form 24 of the CBCA Regulations; British Columbia Securities Commission, Policy No. 3-23, April 13, 1977, 2 CCH Can. Sec. L. Rep. ¶ 29-973; Alberta Securities Commission Policy No. 3-10, May 15, 1971, 1 CCH Can. Sec. L. Rep. ¶ 24-510; Quebec Securities Commission, Policy No. 22, September 20, 1973, 3 CCH Can. Sec. L. Rep. ¶ 66-076.

47 *See e.g.* Canada Act, ss. 100.1(6)-(8).

the use of agents, nominees and other secretive activities will contravene the spirit of the controls.[48] Insider reporting obligations must be seen to extend to the visible parties with access to confidential information but the application is hardly exclusive with its omission of other classes of "insiders". Fundamentally, the reporting obligations exclude from their ambit as many persons with access to confidential information as they cover.

To date, Canadian legislation and proposals for its change have not enunciated a concern with the breadth of current regulation but there has been consideration of the omissions. The CBCA contains a minor deviation from the Canada Act which could require increased reporting by trust companies in whose names securities are registered.[49] Ontario Bill 30 has heightened reporting obligations when the insider uses agents, nominees or custodians of securities.[50] However, the CBCA and Ontario Bill 30 hardly contain or propose real improvements. The effort has been limited to visible abuses, such as, for example, cases where there is a deliberate effort to conceal. There has been insufficient consideration of the attendant price that is exacted. At best, the current system requires many more reports than are reasonably required with the result that the administrative costs and number of defaults are high.

The issue of which insiders should report is inherently one that requires a compromise solution. Legislation imposing reporting obligations cannot apply to everyone who may know or have access to confidential information. But, to date, the compromise in the legislation has taken the form of identifying the parties who should report, requiring them to report on every holding and each subsequent transaction and, with each revision of the legislation, to consider increasing the numbers required to report without being exclusive of the class. Legislation has always responded to the question of "who should report" by embracing as wide a class of persons as was considered feasible at the time.

It is instructive that, in comparable jurisdictions which impose reporting requirements, none has imposed obligations on "affiliates" and insiders of corporate insiders.[51] While these jurisdictions could have followed the Canadian example, it may be

48 The U.S. experience in this regard is documented in SEC, Preliminary Report on the Practice of Recording the Ownership of Securities in the Records of the Issuer in Other Than the Name of the Beneficial Owner of Such Securities 18-19 (1975).

49 *See* CBCA, s. 2 (definition of "beneficial interest"); CBCA, s. 228(1) (provisions permitting investigations).

50 *See* Ontario Bill 30, s. 106.

51 *See e.g.* W. Painter, Federal Regulation of Insider Trading 144 (1968 & Supp. 1976).

presumed that the price to be paid for increased disclosure outweighed the ostensible benefit from a more broadly based reporting obligation. It may also be that, if the liability provisions are sufficiently broad or if a substitute can be found, there is no need for regular reporting from so broad a class of persons. Furthermore, the supposition of actual access of all who are currently covered by Canadian legislation may not be a valid assumption. The reporting obligations should be reexamined in light of the experience of other jurisdictions to determine whether so many must report.

On a similar basis, the question should be asked whether, if the number of reporting insiders is great, it is helpful that all transactions be reported. If the wife of a company's president buys 50,000 shares of the company, the market could have an immediately justifiable interest just as it could gauge the materiality of such a transaction. This transaction would not be reported in most Canadian jurisdictions. On the other hand, if a vice-president of the company exercises his company stock option over or made a gift of, for example, 500 shares of the company, such a transaction would be recorded. These examples underline an apparent inconsistency in the legislation. While the market may be less concerned with insider transactions just because they are for the account of an insider, the legislation is responsive only to whose transaction rather than the substance of it. In searching for a rationale for which insiders should report, the question should more accurately be framed "who should report what" rather than "who should report".

There is a broad class of persons whose material transactions are of critical importance and, provided that the arbitrary general obligations in current legislation are avoided, such information can be elicited and the duty to report need not be onerous. A director, officer or influential shareholder should indicate which securities he owns or controls and, as the avoidance of reporting can be so easily effected through the use of "associates", nominees or custodians, such an insider should be obliged to include as part of his holdings of securities the holdings of associates. Current legislative provisions which permit an influential shareholder to report on behalf of himself or itself and give effect to the holdings of affiliated companies should be clarified, preserved and expanded to require reports on the holdings of associates of influential shareholders.[52] A report of an issuer should give details of the

52 At present, the abbreviated procedures referred to in note 47 *supra* are permissive ("a report...shall be deemed"). The same applies with the CBCA provisions; there is no obligation for a single filing. These provisions should be mandatory.

holdings of its affiliates and associates.[53] The foregoing would expand somewhat the class of insiders whose transactions are covered by reports but should decrease the numbers of reports and persons required to file them.[54]

Whether individuals who are insiders of corporate insiders should be obliged to file reports raises a significant question. On the one hand, the potential for abuse from such insiders is great. At the same time, there is merit to a position asserting that an officer of, for example, a European or Asian affiliate of an issuer should not have to report his transactions.[55]

Furthermore, there are significant jurisdictional issues when so broadly based an obligation applies to individuals outside Canada.[56] On the basis that none of the arguments on this issue are completely persuasive and that any compromise is unnecessarily arbitrary, it is suggested that the current provisions requiring individual insiders of corporate insiders to report, subject to the exemptions hereinafter suggested, be preserved.

D. FILING OF REPORTS

1. *General*

Insiders of the company are obliged to report on their beneficial ownership, control or direction over securities of their company.[57] A report will disclose the insider's holdings of securities of the company and, except for the CBCA provisions which are somewhat different, the acquisition or disposition by an insider of a put, call or other transferable option respecting a security is deemed to be a change in the beneficial ownership of the underlying security and must be reported.[58] The provincial statutes deem ownership to pass upon acceptance of an offer to purchase or

53 To the extent that a prohibition such as is contained in s. 19 of the Canada Act does not prevail, the issuer should be responsible for these insider reports as well.

54 It would be anticipated that there would be only one report for each major shareholding. There appears to be a prevailing practice where several companies in a chain of control file separately thereby increasing the number of reports and adding to the confusion. This should be avoided.

55 *Quaere* whether insider reporting in Canada will assist foreign purchasers or sellers of securities or whether the legislation should protect where Canadian residents are not parties to the transaction. Such a person's access to confidential information is also suspect.

56 *See generally, Hebenton & Gibson.*

57 *See e.g.* Canada Act, s. 100.1(1); CBCA, s. 122, and CBCA Regulations, form 24; Ontario Act, s. 110(1). The deviations in the wording of these sections do not appear to be material.

58 *Compare* Canada Act, s. 100(2)(e), *and* Ontario Act, s. 109(2)(b), *with* CBCA, s. 121(2)(c).

sell.[59] Insider reports, therefore, relate to ownership of and transactions in any securities of the company but there are some material deviations in the reporting procedures.

The Canada Act and the CBCA contain unnecessary departures in reporting procedures. Both statutes do not state precisely when the transaction at issue should be reported as do, for example, the provincial statutes which deem ownership to pass at a point in time. A person who agrees to buy securities of the company by contract dated the thirtieth day of a month to be completed on the twentieth day of the next following month would, under provincial law, have acquired the securities on the thirtieth whereas, under the federal statutes, he would have acquired them on the twentieth. Similarly, in the CBCA, it is provided that the acquisition or disposition of an option or right is deemed to be a change in beneficial ownership whereas, under the Canada Act and provincial statutes, it is the acquisition of a put, call or other *transferable* option that causes a change in ownership. For immediate purposes, the example of employee stock option plans demonstrates that, under the CBCA, the acquisition of the stock option gives rise to a reporting obligation whereas, under the Canada Act and provincial statutes, the exercise of the option must be reported. Until the option is exercised, the option was not "transferable".[60] These slight deviations should cause significant concerns for insiders who must file in several jurisdictions.

Insiders must report within specified time periods and such reports must be lodged with the applicable regulatory authorities. On becoming an insider, a person must file an initial report to disclose his holdings within ten days of the month after the month in which such status is obtained.[61] Under the CBCA and in British Columbia, Alberta and Québec, "Nil" reports must be filed, as the case may be.[62] Reports of subsequent changes in holdings of securities must be filed within ten days of the month following the month of the transaction.[63] The reports are available for public inspection and summaries thereof are periodically published by the regulatory authorities.[64]

The reporting obligations in other jurisdictions compare with the Canadian obligations. In Britain, Australia and New Zealand,

59 *See e.g.* Ontario Act, s. 109(2)(c). This presumably ignores the time of settlement, *see* D. JOHNSTON at 290, but may give rise to difficult conflicts where securities are not bought on an exchange as described in the text following.

60 Canada Act, s. 100(2)(e); Ontario Act, s. 109(2)(b); CBCA, s. 121(2)(c).

61 *See e.g.* Canada Act, ss. 100.1(1)-(3).

62 *See* material on "Nil" returns at note 46 *supra*.

63 *See e.g.* Canada Act, s. 100.1(4).

64 *See e.g.* Canada Act, s. 100.2(3); public inspection is permitted under Canada Act, s. 100.2(1).

insiders must report to their companies on their initial interests and subsequent transactions in securities and such reports are required within fourteen days of the event giving rise to the reporting obligation.[65] However, this obligation to file is significantly broadened in the case of companies which are listed on a stock exchange. As mentioned above, The [London] Stock Exchange requires insiders of listed companies to report to the exchange and, except for insider transactions involving a change in control, there is no comparable obligation in Canada.[66] In these Commonwealth countries, the principle of reporting is comparable but the obligations are somewhat different.

In the United States, there are more significant differences in the reporting obligations. Rule 16a-9 under the 1934 Act gives an exemption from the reporting requirements for small transactions so that the reporting requirements do not apply to all transactions.[67] The SEC has been careful to enunciate, pursuant to formal rules and interpretative releases, how various transactions and interests such as stock options, interests in trusts, etc.,are to be treated for reporting purposes and, therefore, some of the difficult interpretative questions have been answered.[68] Section 16(e) of the 1934 Act gives a specific exemption for market-makers in securities and Rule 16e-1 extends an exemption for arbitrage transactions.[69] The procedure for filing reports is somewhat different than in Canada since, if the company's securities are listed on an exchange, the reports must also be filed with the principal exchange on which the company's securities are listed.[70] United States regulation is more precise in defining the obligations and, while this may not involve great substantive differences, there is the benefit of greater clarity in the legislative provisions.

Canadian legislation on the filing of insider reports should be reconsidered. At present, every insider transaction must be reported without discrimination as to what information is being furnished and why it has been required. Whether the transaction is of great significance, such as the sale or purchase of a large block of securities, or relatively insignificant, such as the exercise of a stock option in the ordinary course or a gift of a nominal amount of securities, the transaction must be reported. In the great major-

65 *See* materials at notes 27-29 *supra*; the U.K. requirement was amended in 1976 to reduce the time period to five days.

66 The Stock Exchange, *supra* note 30.

67 Rule 16a-9, *supra* note 41.

68 *See* material in note 41 *supra*.

69 *Compare, e.g.* Canada Act, s. 100.1(1), "insider" (b).

70 Note Rule 16a-1(c), 17 C.F.R. s. 240.16a-1(c) (1977), whereby insider designates principal exchange and filing with the company is provided by Rule 13d-1, 17 C.F.R. s. 240.13d-1 (1977).

ity of cases, insider transactions will neither be evidence for subsequent legal proceedings, give the market the insider's assessment of the company's securities nor do more than create a bothersome obligation for the insider. This extensive reporting must add large administrative costs to the processing and dissemination of information about insider reports. There is the risk that a material transaction of an insider will be overlooked in that such a transaction will be camouflaged among the reports of many insignificant transactions. Some effort must be made to distinguish between transactions of interest to the market at large and those of lesser import.

It is submitted that there are three types of transactions which involve an insider, namely, a transaction of interest to all segments of the market, one of interest to the small segment of the market which follows insider reports *per se* and, finally, the type effected in good faith, without improper purpose but being of interest to the company's shareholders. The type of transaction which would be of interest to the market at large is one where a substantial block of securities changes hands. Whether or not such a block of securities affects control of the company would be secondary since, in any case, the insider's involvement in a large trade is material. At the other extreme, the exercise of non-transferable stock options, a gift of shares to a child, the purchase or sale of small numbers of securities and dispositions of securities within the controlling group do not necessarily indicate the insider's motive or demonstrate material facts. Indeed, the latter transaction can be misleading.[71] Between these extremes, transactions are material but that would depend on how closely one is following the securities or fortunes of a particular issuer. Within this framework, it is suggested that a more rational reporting obligation can be framed.

In the case of "small transactions", these transactions are of academic interest to the market at large but they may be of significance to shareholders of the company. A small transaction exemption is warranted under which monthly reporting need not be made of transactions having a value of, for example, up to $10,000 or $15,000, the exercise of stock options, gifts of securities involving no consideration, transactions involving a change of ownership but no change in the position of insiders as a group.[72] As

71 For example, an insider of a company may exercise stock options granted over the years merely because they are expiring and not out of interest in the company's immediate prospects. An insider's estate planning may appear to involve substantial sales but may in fact be no more than an "estate freeze".

72 The OSC has responded to this problem to a very limited extent with respect to payroll deduction stock option plans; *see* D. JOHNSTON at 294. *Quaere* whether the

these transactions may be material in the aggregate or, in themselves, material to shareholders of the company, they should be reported upon, and it is submitted that sufficient reporting could be effected by including such information in reports of management to its shareholders. The substantive issues raised by a reporting obligation would not be ignored by such staggered reporting whereas the obligations on the insider and the administrative and enforcement questions would be significantly reduced.

A further exception would be for "block transactions" which should be reported upon more quickly. Any definition of "block transactions" would be arbitrary but, for immediate purposes, the lesser of 5% of shares of an outstanding class and $500,000 aggregate monetary value would indicate the type of substantial commitment by an insider that an accelerated reporting obligation should cover. In the case of block transactions, a time period following the date of the transaction consistent with timely disclosure of material corporate events should be considered as the time for reporting.

The existing system of reporting should be preserved except for the "small transactions" exemption and the treatment of "block transactions". In these reports, a significant number of insider transactions would be reported upon[73] and the general impact of insider trades could be traced. Such reports could also provide information where the cumulative impact of "small transactions" became material. This monthly system of reporting complemented by accelerated reporting for material transactions and annual reporting for the less significant ones should be responsive to the purposes of insider reporting.

In framing the reporting obligations, it is essential that clarity and consistency be sought. A concerted effort should be undertaken following which similar transactions will be treated in approximately the same fashion regardless of which reporting system is being examined. For example, there is dubious value to having insiders file "Nil" reports since there is no benefit to knowing that an insider owns no securities.[74] An insider is entitled to report the same transaction at the same time and in the same

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administrators should require the costs and occasion the difficulties attending formal applications for exemption.

73 Some consideration might be given to a sliding scale for the exemption for small purchases and sales. Clearly, a $10,000 or $15,000 exemption will vary in importance with the price of the security and greater numbers of reports for higher priced securities may not be desirable.

74 D. JOHNSTON at 291 and P. ANISMAN at 109, n. 3, trace the arguments. It is submitted that the costs of obtaining "Nil" reports far exceed the benefit of knowing who the insiders are.

fashion under all reporting provisions. While this may create difficulties with provincial administrators, it is suggested that an insider, having decided to report, should not be required to understand the nuances of several different jurisdictions in meeting his duties.

2. *Timing of Reports*

The issue of when insider reports should be filed raises a number of considerations. In view of the purposes for which insider reporting obligations are imposed, contemporaneous reporting of material transactions would be invaluable. However, the desirability of immediate reporting must be weighed against the consideration of how onerous an obligation immediate reporting would create. The current system of reporting is a compromise between these two considerations. Monthly reporting has been deemed reasonably timely by the legislation.

There is an exception to this compromise in provincial legislation.[75] Any person who makes open market acquisitions of a 20% interest in the voting securities of a company must report within three days and each subsequent acquisition of 5% must be reported upon within three days. The accelerated obligation supersedes the obligation to file monthly reports and complementary provisions regarding summary and publication of reports are provided. At present, the accelerated obligation is expressly limited to open market purchases. This provincial position on accelerated reporting compares with similar provisions in the United States[76] and in the Commonwealth countries[77] and follows the proposals contained in the *Ontario Securities Commission Disclosure Report*[78] which proceeded from the assumption that a one-month delay in the reporting of an actual or imminent change of control was too long.[79] And Ontario Bill 30 would expand the provincial position so that it would not be limited to open market purchases. However, the federal position, as well as that of several of the provinces, has been against the imposition of an accelerated reporting obligation[80] and there are arguments to be made questioning the effect[81] or value[82] of such provisions. There are obvious inconsist-

75 *See e.g.* Ontario Act, s. 110a.

76 *Compare* the 1934 Act, ss. 13(d), (e).

77 *See e.g.* Companies Act 1967, U.K. 1967, c. 81, s. 33; and Companies Act, 1961, Victoria, Acts of Parliament, 10 Eliz. 2, No. 6839, s. 69D.

78 Ontario Securities Commission Disclosure Report.

79 *Id.* ¶¶ 7.11-7.14, 7.36(3).

80 Note that neither the Canada Act nor the CBCA has adopted this position. Similarly, it has not found favour in B.C., Québec or the eastern provinces.

81 *See* P. Anisman at 111.

82 *See e.g.* 1 Business Corporations Proposals ¶ 429.

encies in the reporting obligations in Canada at present and this should not continue.

In order to determine the appropriate time frame for reporting, it would be worthwhile to reconsider the reasons for having a reporting obligation at all. If the only considerations relating to when reports should be filed were to create evidence for subsequent legal proceedings and to advance the salutary effect of insider reporting on the insider himself, the fact that a report is required at any time within the prescription period for litigation would be sufficient. However, the issue of timing becomes acute if the reporting system will give credence to the rationale that knowing an insider's behaviour is of benefit to the market at large. Reporting *per se* is not sufficient but, rather, any such consideration leads to the conclusion that, without a determination of what constitutes timely reporting, the system breaks down.

If the materiality of different types of transactions is determined and the reporting system adjusted, as suggested above, the issue of timeliness becomes less difficult. The principal obstacle to contemporaneous and, therefore, most timely reporting is that the price exacted would be too great for all insider transactions. But, if the legislation segregates between types of insider transactions, a more flexible system would prevail. A substantial delay in the reporting of small transactions being permitted would give rise to a significant reduction in the number of insider transactions at issue generally. From that basis, the few block transactions could be segregated and an insider should be obliged to report them as soon as possible. This position would permit the remaining insider transactions to be left in the monthly reporting system.

The time periods for reporting must be relatively arbitrary. In the case of "small transactions" these should be reported by management of the company in its reports to shareholders. Whether these are done on a quarterly, semi-annual or annual basis is not material and, in any case, as reports to shareholders are filed with regulatory authorities, this could effect the public filing that may be desirable. Contemporaneous reporting of block transactions, for example, within two business days, should be rationalized as a material change in the affairs of a company and, as companies are required to make immediate disclosure to securities commissions and stock exchanges at present and under any proposed form of continuous disclosure,[83] insider reporting in these circumstances should be treated similarly. Together with the system for small

83 *See e.g.* Uniform Act Policy No. 2-12, revised December 6, 1971, 2 CCH CAN. SEC. L. REP. ¶ 54-822; and Ontario Securities Council Policy No. 3-23, December 6, 1971, 2

transactions and block transactions, a relatively workable system for monthly reporting would be retained.

3. *Publicity in Reporting*

Insider reports filed with a regulatory body responsible for publishing summaries of them provide a limited publicity function. In order for an observer to determine insider trading activity promptly, he must attend at the office of the regulatory authority and examine the reports. Parties that are interested but more passive may await the periodic publication of results in reports of the regulatory bodies or rely on the limited and selective summaries of insider reports published by the financial press. In any case, the total dissemination of insider report information is narrow.

A corollary to the issue of timing of reports is the fact that the information contained in published summaries is always quite old. At a minimum, the obligation to file, the earliest inspection and first publication may not be completed until the tenth day of the month following the transaction. If an insider has satisfied the accelerated reporting obligations, the obligation to file within five business days means that first inspection and subsequent publication is not possible until one week after the transactions are completed. Consideration of insider reports by the public may become a rather academic exercise.

Insider reports should be more broadly publicized and procedures established for the earliest and widest possible dissemination of information. Reports should be filed with stock exchanges since, at least, inspection procedures are thereby extended. In the case of block transactions, exchange and newspaper services should be more widely employed. While the regulatory authority cannot require the public to review reports, it should be striving to make the information contained therein as widely available as possible and, to that end, it should not be relying so heavily on its own publication for dissemination of information.

E. EXEMPTIONS

1. *Procedural*

The statutes regulating insider trading in Canada, or the regulations thereunder, provide for an abbreviated reporting obligation. A company is permitted to file an insider report on behalf

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CCH CAN. SEC. L. REP. ¶ 54-918; *see also* Ontario Bill 30, pt. XVII; and *Grover & Baillie.*

of itself and its subsidiary companies. An individual may file an insider report on his own behalf as well as on behalf of companies he controls and companies affiliated with his controlled companies. Such provisions do not exempt subsidiary and affiliated companies as such but, as a procedural matter, if a controlling company or individual files a detailed report, a significant number of reporting obligations are satisfied. Since the subsidiary or affiliated company remains primarily liable to file insider reports, there is some exposure where an insider relies on controlling companies or individuals to file reports on its behalf.

A second type of procedural exemption is obtainable on application to the regulatory authority. Insiders are permitted, customarily, to file reports on the forms prescribed by the primary regulatory jurisdictions and will not be required to use the local forms. Alternatively, the regulatory authority may require a first filing on its own form and subsequent filings are permitted on the primary jurisdiction's forms, this variation being customary where the secondary jurisdiction would otherwise receive no reports. As an example, a federal company may make application in Ontario on behalf of its insiders so that the insiders will be permitted to file reports on the federal insider reporting form with the Ontario Securities Commission (OSC).[84] There is, however, no variation in the substantive obligations.

2. *Substantive*

Although some of the provinces have dispensed with the need for a formal application,[85] insiders may be exempted from substantive obligations to file upon application to the regulatory body. The most commonly articulated justification for exemption is that selected insiders are remote from access to confidential information and, therefore, could not be involved in abuses.[86] Similarly, some of the provincial statutes and regulations provide expressly that, if the company has no local connection its insiders are not required to file insider reports.[87] Often, the justifications for substantive exemption are intertwined and an example of the types of

84 *See e.g.* Ontario Securities Commission, Policy No. 3-16, April 5, 1971, 2 CCH CAN. SEC. L. REP. ¶ 54-910.

85 *See* Alberta Securities Commission, Policy No. 3-12, May 15, 1971, 1 CCH CAN. SEC. L. REP. ¶ 24-512, Saskatchewan Securities Commission, Policy No. 6, effective July 1, 1972, 3 CCH CAN. SEC. L. REP. ¶ 69-307; Manitoba Securities Commission, Policy No. 3.08, June 1, 1972, 2 CCH CAN. SEC. L. REP. ¶ 34-998; Quebec Securities Commission, Policy No. 22, *supra* note 46.

86 *Id. See also* Re British American Oil Ltd., [1967] OSC Bull. 9 (June); D. JOHNSTON at 291.

87 *See also* materials in note 85 *supra*.

considerations that would apply is the application and exemption for insiders of Sony Corporation in Ontario.[88]

The insiders of Sony Corporation were exempted entirely from the obligation to file insider reports by the OSC in advance of the company's application to list its American Depositary Receipts on the Toronto Stock Exchange. Insider reporting was alien to legal obligations applicable in Japan, Sony's jurisdiction of incorporation, and an argument respecting conflicting legal obligations was made. Sony's insiders had been availing themselves of the foreign issuer exemption pursuant to the 1934 Act in the United States[89] so that a law of a jurisdiction containing substantially similar requirements as Ontario's had viewed the Sony case favourably. Sony's insiders were remote from Canadian facilities by which to take advantage of confidential information and it would be unlikely that Canadians would be harmed. For jurisdictional and geographic reasons, insider reporting obligations might not be enforceable. Finally, implicit in the OSC's consideration, denial of the exemption might contribute to making Sony's securities unavailable to Ontario residents. The considerations on this application demonstrate the varied nature of the arguments that can be raised.

Exemption applications have been quite common and most of the regulatory authorities have published policy statements and guidelines to assist applicants. Of these published statements, a draft Information Statement No. 9[90] under the Canada Act is the most detailed and demonstrates much of the current concern of the regulators. Unless special circumstances can be shown, Consumer and Corporate Affairs Canada citing as its example the participation by an insider in a stock-investment plan for employees, exemption orders will not generally be granted to each of the following insiders: (i) directors and officers, (ii) affiliates, (iii) directors and officers of controlling companies, (iv) important subsidiaries, (v) directors and officers of affiliates engaged in research, development or exploration, the announcement of whose reports could materially affect the value of the company's securities, and (vi) directors and officers of affiliates supplying essential materials or services to the company. In any case, exemption orders will not generally be given for longer than three years from the date of issue. It would appear that exemption orders could be somewhat more difficult to obtain than might have been expected.

88 OSC Weekly Summary, July 25, 1974, at 4A (it may be noted that counsel for the applicant in the matter was the law firm with which the writer was associated at the time).

89 "Foreign Issuer Exemption" appears in Rule 3a12-3, 17 C.F.R. s. 240.3a12-3 (1977).

90 4 CCA Bull. 7 (December 1974).

The approach toward exemptions should be flexible and, it is submitted, not along the lines enunciated by the federal department. In considering exemption applications, the regulator cannot hope to isolate every avenue of potential abuse by someone with presumed access. Applying the federal department's guidelines, every affiliated company engaged in research and development or supplying any product or service can be seen to either make a discovery materially affecting the market price of the parent company's shares or to be supplying an essential good or service. However, where the reporting system imposes such wide corporate and personal obligations, the risk of abuse of confidential information should be considered more carefully. The departmental position appears to indicate a substantial number of situations where it would be indisposed to grant an exemption whereas its position should be that, upon demonstration of lines of reporting and information flow within a corporate organization, an exemption should be granted. The department's position on exemptions should not be to attempt to preserve the great number of reports that are already being filed (and would be proliferated further with the need for "Nil" reports) but to work toward a more pragmatic approach to insider reporting. After all, the exemption from reporting does not operate to exempt from liability for abuse of confidential information.

F. SANCTIONS AND ENFORCEMENT

1. *Penalties*

Each of the Canadian jurisdictions provides penal sanctions for failure to file insider reports and for filing false or misleading reports. Individuals, as well as directors and officers of corporate insiders, may be found guilty of an offence and liable to penalties.[91]

In addition to penal sanctions, the regulatory authorities may avail themselves of administrative remedies. A regulatory authority may seek a compliance order requiring an insider to file his reports[92] or use its investigative powers to determine the factual background from which other liabilities may be invoked.[93] The OSC has a policy not to grant a prospectus receipt to an issuer whose insiders are in default of their reporting obligations.[94] An

91 *See e.g.* Canada Act, ss. 100.3(1), (2).
92 Canada Act, s. 100.3(5).
93 *See e.g.* Ontario Act, s. 21.
94 Ontario Securities Commission, Policy No. 3-04, April 18, 1974, 2 CCH CAN. SEC. L. REP. ¶ 54-898.

insider may be denied the statutory exemption which he requires in order to trade in securities by a regulatory authority.[95] Any remedy available under the authorizing statute may be used depending on the factual background.

To date, there have been few reported prosecutions expressly based on a failure to file insider reports and no reported instances of actions against the filing of false or misleading reports. In that regard, the OSC obtained a compliance order pursuant to section 143 of the Ontario Securities Act and the remedy granted by the Supreme Court of Ontario was to restrain the insider from violations of that act by trading without filing insider reports.[96] The order required future compliance with the insider reporting obligations.

2. *Administrative Record*

It is apparent that many insiders have ignored their reporting obligations. The OSC, in a policy statement, has confirmed that many have neglected their obligations and that a more aggressive administrative posture will be taken in the future.[97] To date, it appears that the OSC has continued to rely on stern warnings and, as it has sought to enforce these obligations to report so rarely,[98] made minimal efforts to change the legislation[99] or to otherwise demonstrate a commitment to the problem, it must be assumed that this is not one of its highest priorities. It is apparent that the failure to file insider reports is a problem which persists under existing legislation.

The insider who files false, misleading or incomplete insider reports has been subjected to several administrative practices. In the case of reports filed in Ontario, the OSC will publish a summary of the report if it does not notice the impropriety. If the information disagrees with existing records, the insider will be advised of the discrepancy and publication consists of noting a transaction without details with an asterisk notation disclosing an error.[100] The only available disclosure to the market is by way of inspection. With filings pursuant to the Canada Act and the CBCA, the practice appears to be that an improper report will be accepted and

95 *See e.g.* Ontario Act, s. 19(5).

96 *See* OSC Weekly Summary, June 13, 1974, at 2A; *but see* Re Saskatchewan Securities Commission v. Premier Products Ltd., 36 D.L.R. (3d) 476 (Sask. Q.B. 1973).

97 Ontario Securities Commission, Policy No. 3-24, January 13, 1972, 2 CCH Can. Sec. L. Rep. ¶ 54-918.

98 There has been only one formal prosecution in Ontario; *see supra* note 96.

99 *See* text *infra* and materials in note 13 *supra*.

100 *See* the inside front cover of any edition of the OSC Bull. ("Guide to Symbols"), where * stands for "returned for reconciliation purposes".

published subject to later correction and republication. None of these procedures is justifiable since they provide for improper or no disclosure.

Ontario Bill 30 has indicated that these problems may be part of a general default in filings. Several exemptions are contingent upon being in full compliance with the proposed act.[101] However, any further revised policy is not apparent from the proposed legislation and, in any case, it is not clear that such provisions are aimed at insider reporting.

There is no legal rationalization for permitting failure to file reports or for the current procedures with improperly filed reports. It is imperative that properly completed reports be processed carefully and published as soon as possible and there can be no justification for legislation and an administrative system which does not complement these motives. Insider reporting obligations should be framed with the view that the required reports will be filed and the publication of incorrect reports or resulting non-disclosure will be avoided.

The apparent reasons for the administrative record with insider reporting may suggest some solutions. As the regulatory authority processes such a great quantity of reports, it may be assumed that no more than a cursory review of individual reports will result. If the sheer number of reports is reduced, part of the administrative problem with improper reports may be solved. In the case of reports which are not filed, since the regulatory body is the only one involved in policing, presumably a stock exchange, its membership and other persons registered to trade in securities could assist the regulatory body in finding non-reporting insiders. It appears that problems with reporting could be curtailed with more active and broadly based enforcement in an environment where fewer reports are required.

Among the considerations with insider reporting is the substantial number of jurisdictions in which reporting is required. An insider may have to report in up to seven jurisdictions in Canada. From the insider's viewpoint, there must be general annoyance with such a broadly based obligation and an attendant ignorance or apathy towards other than the local jurisdiction. There is an evident "home jurisdiction bias" with, for example, the Ontario resident who has filed with the OSC and feels he has complied with all the applicable laws. Furthermore, whether as a matter of priorities a regulatory body in a province would prosecute out-of-province insiders is debatable notwithstanding that, in theory, each of the regulatory bodies has staff policing the insider report-

101 *See e.g.* Ontario Bill 30, s. 73(5)(a).

ing provisions. Centralization and perhaps integration of insider reporting obligations would encourage insiders to report and enforcement would be more precise.

Another of the reasons why insider reporting obligations have yielded limited results is the fact that the sanctions and remedies for improprieties are not being used to their full extent. It is understandable that a regulatory body will be hesitant to seek criminal penalties except in extraordinary situations because a publicized criminal prosecution has unsavory side effects and an impact that may be too great for the impropriety.[102] But, in the case of compliance orders, this less stringent sanction should have been sought more often notwithstanding such a proceeding involves an application to court, publicity and significant impact if small transactions are involved. Remaining remedies in the statutes appear to have been largely unnoticed. While existing procedures may be adequate on their face, they have not been used sufficiently and there is little sign that more aggressive postures will be taken.

Abbreviated procedures and less expansive penalties should have been sought to enforce the reporting provisions. The OSC's attempt to impose a sanction on the issuer[103] is a convenient remedy for reports which are an obligation of that issuer; it is clearly inapplicable for cases where an individual is in default and the company is not to blame. For individuals, publicity is the best warning and should be followed shortly thereafter with applications for compliance orders or suspensions of trading exemptions. If an individual's defaults are published in the regulatory body's report of transactions, that individual should respond to such unfavourable comment and any failure to respond indicates sufficient wilfulness for the imposition of more onerous sanctions. The emphasis of the regulatory authorities and in the sanctions must be publicity and the administrative tools are already available.

102 While, for example, Ontario Act, s. 144, provides a small sanction with a fine of up to $1,000, a securities commission would be understandably reluctant to investigate a public hearing with attendant publicity for what may be honest oversight or misunderstood obligations. Such hearings, involving a relatively small industry, have a "branding effect".

103 *E.g.* an order pursuant to Ontario Act, s. 144; an investigation of trading in the company's securities pursuant to Ontario Act, s. 21; application of Ontario Securities Commission Policy 3-04, *supra* note 34 ¶ 2(d) (grounds for refusal to issue receipt for a prospectus).

Chapter III
Insider Liabilities

A. COMMON LAW LIABILITIES

1. *In Favour of Shareholders*

The leading case governing an insider's liabilities to shareholders of the company at common law is *Percival v. Wright*.[104] The chairman of the board and two other directors of the company bought shares from existing shareholders without disclosing to them the existence of negotiations for a sale of the company's undertaking. The plaintiffs were unsuccessful in an action for rescission and the generally accepted interpretation of the judicial opinion is that, at common law, directors do not owe a fiduciary duty to individual shareholders of their company and, therefore, cannot be liable. By implication, directors do not owe such a duty to prospective purchasers of the company's shares. On the basis of insider trading only, there would be no liability for directors and officers. The principle of this case has never been doubted in any reported English case.[105]

The case of *Percival v. Wright* has been criticized[106] and distinctions have been drawn in subsequent cases. In the case *Allen v. Hyatt*,[107] the court imposed a duty on directors in favour of their shareholders on the basis that the directors under consideration had been appointed agents of their shareholders.[108] Similarly, from *dicta* in *Pickford v. Thompson*[109] and the decision in *Gadsden v. Bennetto*,[110] Canadian courts have suggested that such a fiduciary duty to shareholders exists on the basis of a "special facts" doctrine.[111] Notwithstanding the criticisms and apparent exceptions, the continued vitality of the principles outlined in the *Percival* case should not be questioned.[112]

The common law position on directors' liability in the United

104 [1902] 2, ch. 421.

105 *See* JUSTICE, INSIDER TRADING: A REPORT ¶ 5 (W. Goodhart Chairman 1972); *but see* Coleman v. Myers (N.Z. Ct. App., August 11, 1977, unreported).

106 *See e.g.* L. GOWER at 546-47; Loss, *Foreword* to A. YORAN, INSIDER TRADING IN ISRAEL AND ENGLAND 7 (1972).

107 17 D.L.R. 7 (P.C. 1914).

108 *Id.* at 10, 12.

109 40 N.S.R. 632 (S.C. 1902).

110 9 D.L.R. 719 (Man. C.A. 1913).

111 *Contra* Green v. Charterhouse Group Canada Ltd., [1973] 2 O.R. 677, 733 (H.C.), *aff'd*, 12 O.R. (2d) 280 (C.A. 1976) whereby the "special facts" doctrine is said to be inapplicable in Canada.

112 *See* L. GOWER at 517 and KIMBER REPORT ¶ 2.03.

States was not materially different. Under what has been described as the "majority" or "strict" rule, a position similar to the *Percival v. Wright* rule was applied in most jurisdictions.[113] A few of the state courts followed a "minority" or "fiduciary" rule which imposed fiduciary standards in such transactions.[114] The remaining states, with what was eventually the most widely followed rule, applied the "special facts" doctrine outlined by the U.S. Supreme Court in *Strong v. Repide*.[115] Professor L. Loss has stated that "[T]his is the dialectic...an advocate can never afford to ignore" but goes on to state that the divisions between the rules are often hard to distinguish.[116]

The duty of controlling shareholders to other shareholders varies more widely in a comparison of the Anglo-Canadian position with the American. In the former case, there is little basis for finding such a duty whereas in the latter such a duty has been found.[117] However, as these early cases involved, for the most part, closely-held companies, controlling shareholders were also directors and officers and distinctions are, therefore, not entirely warranted.

Such common law rules do not offer significant protections. In the absence of a court's finding of a special duty or fiduciary relationship, the most likely conclusion from litigation would be that the insider is not required to disclose information affecting the value of shares that are the subject of a transaction or to refrain from trading. Government reports have gone so far as to suggest that, even if the *Percival* case were expressly overruled, the fiduciary relationship would apply only to dealings with directors and there would be no automatic extension of liability to a broader category of insiders.[118] The lesson from these cases, which has not been tested extensively where open market transactions are involved,[119] is that legislation was necessary in order to enunciate the principles of liability and to formulate the nature of the relief to be granted.

113 *See* 3 L. Loss at 1446.

114 *See e.g. id.*; and Oliver v. Oliver, 45 S.E. 232 (Ga. 1903); essentially directors should disclose all material facts not otherwise public.

115 213 U.S. 419 (1909); *but see* Brown v. Halbert, 76 Cal. Rep. 781, 788 (1969). Essentially this is an application of the "minority" rule where there is great disparity in the perceived values of shares.

116 *See* Loss, *supra* note 106.

117 *Compare* Fergusson v. Wallbridge, [1935] 3 D.L.R. 66 (P.C.); L. Gower at 563; Magnusson, *supra* note 6 *with* 3 L. Loss at 1446, n. 4, *and* Brown v. Halbert, *supra* note 115.

118 *See e.g.* 1 Business Corporations Proposals at 90, 91.

119 *See e.g.* Goodwin v. Agassiz, 186 N.E. 659, 661 (Mass. 1933), where, in a widely criticized *dictum*, the "special facts" doctrine was said not to apply to stock exchange transactions.

2. *In Favour of the Company*

The liability of insiders at common law to their companies has been described as follows:

> "The position of the corporation...is not, in our view, nearly so exposed as that of the individual shareholder. Existing rules are perfectly well adaptable to cover the case of an insider, whether director or not, making use of confidential information for his own benefit or advantage. Well-settled law about breaches of confidence, misappropriation of corporate assets, secret profits and conflicts of interest and duty are, in our view, adequate to the point, and their application to the case of insider trading, while not free of difficulty, does not present the same doctrinal problems as does their application to the relationship between insider and shareholder. Indeed, quite apart from the results on the facts, the decisions in a number of recent cases, such as *Peso Silver Mines Ltd. v. Cropper* (1966) 58 D.L.R. (2d) 1 and *Boardman v. Phipps* [1967] 2 A.C. 46 amply demonstrate the flexibility of this body of law. It should also be said that, in most cases, improper share trading by an 'insider' of a corporation will not in any event cause a loss to the corporation, however unfair it may be to individual shareholders of that corporation."[120]

It may be that the duty of insiders to their companies is sufficiently established for the courts to enable companies to recover from their insiders. However, in Britain and Canada, there has been no reported judicial decision which has permitted such recovery. Notwithstanding that the courts in Canada have spoken favourably about the duties which would lead to liability[121] and that, in the United States, several state courts have taken initiatives in this area to permit recovery by the company,[122] the issue of whether a company can recover insider profits in Canada by means of a common law remedy must be seen as unresolved.[123]

120 1 Business Corporations Proposals at 90, 91.

121 *See e.g.* Canadian Aero Service Ltd. v. O'Malley, [1974] S.C.R. 592 and cases cited therein.

122 *See e.g.* Diamond v. Oreamuno, 238 N.E.2d 910 (N.Y. 1969).

123 It may also be noted that the enforcement procedure is not straightforward, *see Anisman* at 172.

B. PROHIBITIONS ON TRADING

Quite apart from the considerations raised by the insider who trades making use of confidential information, there are several prohibitions imposed by legislation against speculation by insiders. The Canada Act states that an insider shall not effect "short sales" in the securities of the company[124] and a similar prohibition appears in the CBCA where an insider is prohibited from effecting such transactions in voting shares of the company and its affiliates.[125] The latter prohibition follows the view expressed in the *Business Corporations Proposals* that there "is nothing to be said in favour in allowing an insider to 'sell short' the shares of a corporation in which he is an insider"[126] and both mirror the attitudes adopted in other jurisdictions.[127] However, in the CBCA, the redrafted offence expands liability to voting shares of affiliates but creates an unwarranted distinction between transactions in voting shares and non-voting securities of the company. These provisions on short sales will not necessarily reduce speculation but will operate to prevent the insider from employing this type of transaction to do so.[128]

A second prohibition in the legislation against insider speculation prevents an insider from purchasing put or call options. Under the Canada Act, an insider may not purchase put or call options in respect of the company's securities and the CBCA extends the prohibition to the voting shares of the company and its affiliates.[129] The CBCA again makes the unwarranted distinction between voting and non-voting securities.[130] Both statutes would reduce leverage in the purchase of options by insiders but they have also, by inference, characterized the purchase of options by insiders differently than the sale of them.[131] And the entire ques-

124 Canada Act, s. 100.6.

125 CBCA, s. 124.

126 1 BUSINESS CORPORATIONS PROPOSALS ¶ 265.

127 *See e.g.* 1934 Act, s. 16(c).

128 *See e.g. Anisman* at 205; ALI FEDERAL SECURITIES CODE, Tent. Draft No. 2, s. 1413, comment (1)(b) (1973).

129 Canada Act, s. 100.6; CBCA, s. 124.

130 The prohibition relates to "shares" which, in CBCA, s. 121(1), are defined as voting securities; *quaere* whether participating but non-voting securities raise different considerations.

131 Presumably, the writing (sale) of "covered" options is lawful; *quaere* whether the writing of options by an insider should be treated differently than the purchase of them. It can be said that the writing of options is an attempt to increase yield on an otherwise stagnant portfolio, that the insider expresses confidence by speculating, that there will be no movement in the price of the underlying security and that this will be disclosed in insider reports.

tion of insider dealings in options takes new dimensions with the increased interest in and liquidity of options in recent years.

There are a number of additional statutory provisions which may be seen as prohibitions on insider trading. Controlling shareholders are prevented from freely selling their securities in that they may be engaged in a "distribution to the public" within the meaning of provincial securities statutes.[132] A recent interpretation of the fraud provisions in the Criminal Code indicates that, in a face-to-face transaction with shareholders of the company, misrepresentations may give rise to criminal sanctions.[133] Foreign ownership restrictions in federal and provincial legislation operate to prohibit insiders and prospective insiders from freely dealing in securities of their companies.[134] This latter group of examples demonstrates areas where an insider may be constrained regardless of his knowledge of confidential information and his speculative intent.

C. STATUTORY LIABILITIES

1. *Introduction*

While there are detailed and extensive statutory liabilities in Canada, it must be remembered that, to date, they have not been extensively interpreted by Canadian courts. One case, *Green v. Charterhouse*,[135] has been tried and proceeded to judgments. *Dictum* on a motion in the case of *Farnham v. Fingold*,[136] which did not proceed to trial, discussed insider obligations. The Supreme Court of Ontario gave an order requiring the OSC to commence an action to enforce liability in the proceeding *In the Matter of Multiple Access Limited* but this case has not yet proceeded to trial on the merits and appears to have been unsuccessful on constitutional grounds.[137] Two other cases have been reported in newspapers as having been settled prior to trial.[138] An inquiry of the OSC ab-

132 *See e.g.* Ontario Act, ss. 35, 58.

133 R. v. Littler, 65 D.L.R. (3d) 443 (Que. C.A. 1974), *aff'g*, 13 C.C.C. (2d) 530 (Que. C.S. 1972) (on the merits); R. v. Littler, 65 D.L.R. (3d) 467 (Que. C.A. 1975), *modifying*, 13 C.C.C. (2d) 530 (Que. C.S. 1972) (reducing sentence). The order for restitution, 65 D.L.R. (3d) at 467, is the most interesting aspect of the case. *See also*, *Johnston*, Comment, 2 CAN. BUS. L.J. 234 (1977).

134 *See e.g.* Foreign Investment Review Act, S.C. 1973-74, c. 46, ss. 19, 20.

135 Green v. Charterhouse Group Canada Ltd., *supra* note 111.

136 [1972] 3 O.R. 688, 695-96 (H.C.); *rev'd on other grounds* [1973] 2 O.R. 132 (C.A.).

137 *See* Multiple Access Ltd. v. McCutcheon, (Ont. H.C. 1973) (unreported); Multiple Access Ltd. v. McCutcheon (No. 2); 11 O.R. (2d) 249 (H.C. 1975), *rev'd on other grounds*, 16 O.R. (2d) 593 (Div'l Ct. 1977).

138 *See* Dow, *How Our First Insider Trading Case Developed*, The Toronto Daily Star, June 24, 1969, at 14, col. 1; Dow, *Hard to Get Details of Unique Insider Case*, The

solved insiders in another case.[139] As will be shown below, statutory insider trading liabilities in Canada are at best uncertain in view of what should be seen as vague statutory language which has not had the benefit of analysis by the courts.

Although there are variations in the legislation imposing statutory liabilities in Canada, the example of section 100.4 of the Canada Act is typical of the rules and states:

> "(1) Every insider of a company, every person employed or retained by the company, the auditor of the company and every associate of the insider and affiliate of the insider...who, in connection with a transaction relating to the securities of the company, makes use of any specific confidential information for his own benefit or advantage that, if generally known, might reasonably be expected to affect materially the value of the securities of the company, is liable to compensate any person for any direct loss suffered by that person as a result of the transaction, unless the information was known or ought reasonably to have been known to that person at the time of such transaction, and is also accountable to the company for any direct benefit or advantage received or receivable by such insider, employed or retained person, auditor, associate or affiliate, as the case may be, as a result of the transaction.
>
> "(2) An action to enforce any right created by subsection(1) may be commenced only within two years after the date of completion of the transaction that gave rise to the cause of action or, if the transaction was required to be reported...then within two years from the time of reporting in compliance...
>
> "(3) For the purposes of this section, every director or officer of any other company that becomes an insider of a company shall be deemed to have been an insider of that latter company for the previous six months or for such shorter period as he was a director or officer of that company."

Toronto Daily Star, June 25, 1969, at 18, col. 2; McMynn v. Tappin Copper Mines Ltd., 56 D.L.R. (3d) 443 (B.C.S.C. 1975) appears to have been settled; *see* The Globe and Mail (Toronto), March 11, 1976, at B2, col. 6.

139 Re Harold P. Connor, [1976] OSC Bull. 179 (June); *see also In re* Archibald Robb, B.C. Securities Commission Weekly Summary, March 2, 1973; *In re* William F. Robertson, B.C. Securities Commission Weekly Summary, March 2, 1973; *see also* Re Robertson, 35 D.L.R. (3d) 451 (B.C.S.C. 1973), *rev'd*, 42 D.L.R. (3d) 135 (B.C.C.A. 1973), *aff'd* (S.C.C. May 27, 1975) (unreported).

The elements of liability pursuant to this section will be discussed in more detail below.

The CBCA effected, as Ontario Bill 30 proposes to effect, significant changes to statutory insider liabilities. Both the federal statute and the provincial proposals varied the class of persons to whom insider liabilities would apply and included "tippees" and Ontario Bill 30 includes "tippers".[140] The CBCA also extended liabilities to insiders of closely-held companies and, while Ontario Bill 30 does not go so far with civil remedies, it suggests criminal liabilities for insiders who violate the proposed statute.[141] These bold directions, however, have not been responsive to several of the problems in the legislation and, therefore, the comments below will be seen as equally applicable to the new laws.

In Britain, current insider liabilities in favour of shareholders are limited to common law obligations. Remedies appear to be governed by the rule of *Percival v. Wright* discussed above except to the extent that the decision may be distinguished by, for example, the rule of *Allen v. Hyatt*.[142] This limited insider trading liability does not appear to expose insiders in Britain to substantial risks of litigation from shareholders.

An insider's liability to the company may be more substantial in Britain, also at common law only, based on the rule in *Phipps v. Boardman*.[143] That case stated, in effect, that a person who acquired confidential information in the course of performing fiduciary duties must account to the company for any benefits he obtains from use of that information. But the questionable nature of this liability has been described as follows:

> "[T]here seems to be no obstacle to such a claim (based on the principle of *Phipps v. Boardman*) in legal theory. In practice, for various reasons, such as the reluctance of co-directors to commence proceedings and the difficulties which the rule in *Foss v. Harbottle* presents to shareholders wishing to bring action themselves, it is probably not to be expected that this remedy will be much pursued even after the support it has been given by *Phipps v. Boardman*."[144]

Although the rules of The [London] Stock Exchange have prohibitions regarding insider trading with attendant liabilities,

140 CBCA, s. 125(1)(f); Ontario Bill 30, s. 133.

141 CBCA, s. 125 "corporation" refers to s. 2; Ontario Bill 30, s. 77; perhaps anticipating the trend, *see* British Columbia Securities Act, s. 111(b) (criminal liability imposed for insider trading).

142 Percival v. Wright, *supra* note 104; Allen v. Hyatt, *supra* note 107.

143 [1967] 2 A.C. 46 (H.L.).

144 JUSTICE, *supra* note 105, at 7.

the scope of such regulation is limited in that the rules apply primarily to takeovers and mergers.[145] Also, as any prohibition is only exercisable by The Stock Exchange against its membership, the effect of the rules of The Stock Exchange may be limited to being an evidentiary base from which to assert common law liabilities.[146]

The issue of insider liabilities in Britain is being reconsidered and will probably result in expansion of existing liabilities and remedies by statute. Criticisms and suggestions that insider liabilities be broadened have appeared in various public and private reports[147] and the reports have been uniform in recommending broad revisions to the law. Generally, the proposed policies have been typified by the following:

> "The efficient operation of the market as a source of capital, as a measure of industrial success and hence as a means of achieving a desirable and efficient disposition of resources, requires that reliable information should be fairly available, and that all investors should be able to back their knowledge and judgment rather than that favoured individuals should be able to take private advantage of confidential information...in principle someone who profits unfairly in this way should be liable at law to the other parties concerned, the person with whom he dealt and the company in whose securities he dealt whose information he used in so doing."[148]

As for the scope of liability which may be expected, the *Justice Report* stated:

> "In our view, the definition of 'insiders' should be a wide one. It should include not merely directors but also employees of the company and any other persons having access, in the course of their employment, business or profession, to confidential information relating to the company...there should be a rebuttable presumption that any insider was aware of information which would be likely to have been known by or disclosed to someone in his position."[149]

Similarly, prior to proposing its bill, the position of the now defeated Conservative government was as follows:

145 *See generally* The City Code on Takeovers and Mergers (U.K. rev. February 1972, amended June 1974).

146 Consider, however, Bedford v. Bagshaw, 4 H. & N. 538, 157 E.R. 951 (Ex. 1859).

147 A relatively complete list of such reports may be found in *Anisman* at 153, n. 3; to this list add Department of Trade, The Conduct of Directors, Cmnd. 7037 (U.K. 1977).

148 Department of Trade and Industry, Company Law Reform 8 (U.K. 1973).

149 Justice, *supra* note 105, at 7.

> "The government's view is that dealing in a company's securities by anyone who, by reason of his relationship with the company or with its officers, has information which he knows to be price-sensitive, should be a criminal offence unless he can show that his primary intention in dealing at that particular time was not to make a profit or avoid a loss."[150]

In the circumstances, fairly broad statutory liabilities may be expected. There is the uniform recommendation that liability be based on general access to information instead of pursuant to a designation of specific insiders who should be liable so that it may be expected that liabilities will be more significant than is the legislative standard prevailing in most of the jurisdictions in Canada.[151] Without existing experience, these proposals for change have limited value.

In Australia, The "Uniform" Companies Acts of most of the states contain insider trading liabilities.[152] Designated insiders may not make improper use of information acquired by virtue of their positions to gain advantage for themselves or others or cause detriment to the corporation.[153] Offending insiders are liable to the corporation for their profit or advantage and to compensate sellers and purchasers for their losses.[154] These Australian provisions are not markedly different in concept from their Canadian counterparts.

The Securities Industry Act of New South Wales contains prohibitions against insider trading.[155] "Where through his association with a corporation...a person has knowledge of specific information relating to the corporation...or to [its] securities...and that information is not generally known but...might reasonably be expected to affect materially the market price of those securities", a criminal offence is committed if such person deals in the securities or divulges the information to another and, similarly, such a person may be liable to compensate sellers and purchasers for their losses and accountable to the company for the benefit obtained.[156] This section is clearly similar to the provisions suggested by the Ontario bill and comparable to the provisions as to civil liability in the CBCA.

In 1974, a federal Corporations and Securities Industry Bill

150 Department of Trade and Industry, *supra* note 148, at 8.

151 As all of the recent reports have proposed an "actual access" test for liability, this is more stringent than all of the Canadian statutes except for the CBCA.

152 Companies Act, 1961, Victoria, Acts of Parliament, 10 Eliz. 2, No. 6839, *as amended*.

153 *Id.*

154 *Id*

155 Securities Industry Act, 1970, New South Wales, Act No. 35 (1970) *as amended*.

156 *Id.* s. 75A.

was introduced in Australia.[157] Sections 123 and 125 created an offence where persons "connected with a prescribed corporation" deal in its securities when they have "possession of information that is not generally available but, if it were, would be likely materially to affect the price of those securities". Similarly, "[a] person who contravenes...is liable to compensate any other person who has purchased or sold securities at a price affected by the transaction...for any loss suffered by that other person as a result of the purchase or sale". The referenced sections in this statute which did not become law are similar to comparable Canadian provisions and offer alternatives for draftsmanship of the elements of offensive behaviour and enforcement actions.[158]

In New Zealand, insider liabilities have been suggested by a government report[159] but, to date, there has been no legislation to effect them.

The existing and proposed statutory controls over insider trading in the legislation and proposals of Britain, Australia and New Zealand are of value for Canadian reference. They provide additional analysis of the problems and suggested solutions. However, there is limited experience with the effects and, indeed, the Canadian experience with legislation of this type is more extensive. For comparative purposes, United States regulation offers a more realistic consideration of alternatives because greater experience and breadth of consideration have isolated and refined consideration of the problems.

In the United States, the 1934 Act contains one prohibition against insider trading *per se* and another which has been interpreted to regulate insider trading notwithstanding that no express mention is made of the subject. The insider trading provision as such is section 16(b) which states:

> "For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable

157 Corporations and Securities Industry Bill, 1974, Commonwealth of Australia, 29th Parliament, 1974.

158 Note particularly the treatment of causation which does not refer to "direct loss...as a result of the transaction".

159 Final Report of the Special Committee to Review the Companies Act, *supra* note 29.

by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection."

The more important control has been section 10(b) of the 1934 Act and Rule 10b-5 thereunder which state:

"[10] It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange...

"(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors....

"[5] It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

"(1) to employ any device, scheme, or artifice to defraud,

"(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

"(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

Together, these provisions have had severe impact in an unclear area of the law.

Section 16(b) was conceived as a limited remedial measure. Its key conceptual features are the designated relationship of the insider to the public issuer and a "short-swing" profit attributable to two transactions within six months. From that base, the remainder of the section relates to the mechanical aspects of litigation pursuant to the section – the exceptions, the forum for an action and the limitation period. This is the companion sanction to the reporting obligation of section 16(a) and provides for an obviously arbitrary remedy. It is apparent that the section was not meant as an exclusive control over the problems it purports to remedy.[160]

Section 16(b) has several features in common with comparable Canadian legislation which provides for recovery by the company. The section relates to public companies, albeit somewhat differently defined,[161] and provides for derivative action and recovery. The insiders who may be liable are specifically designated and mirror the class of insiders subject to the reporting obligation of section 16(a). It immediately precedes the prohibition against insider short sales of section 16(c). Canadian legislation has clearly borrowed from this legislative example.

However, section 16(b) differs markedly from Canadian legislation as well. Pursuant to section 16(b), the successful claimant must prove (i) insider status throughout the six-month period,[162] (ii) a purchase *and* sale of an equity security,[163] (iii) the six-month period within which the two transactions took place,[164] and (iv) the profit realized by the insider.[165] The only defences relate to how the mechanical rule is to be interpreted[166] and, until recently, there was no issue of blameworthiness, improper use of confiden-

160 *See* Ward LaFrance Truck Corp., 13 SEC 373 (1943); *contra* MANNE, *supra* note 3, chs. 1-3.

161 1934 Act, s. 12(g).

162 *See e.g.* Stella v. Graham-Paige Motors Corp., 104 F. Supp. 957 (S.D.N.Y. 1952), *rev'd on other grounds*, 232 F.2d 299 (2d Cir. 1956); *see* more recently Foremost-McKesson Inc. v. Provident Sec. Co., 423 U.S. 232 (1976).

163 *See e.g.* Park & Tilford v. Scholte, 160 F.2d 984 (2d Cir. 1947); Blau v. Lamb, 363 F.2d 507 (2d Cir. 1966); *see* more recently Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582 (1973); *but* the issue appears to be resolved in Foremost-McKesson Inc. v. Provident Sec. Co., *supra* note 162; Santa Fe Indus. Inc. v. Green, 97 S. Ct. 1292 (1977).

164 *See e.g.* Lockheed Aircraft Corp. v. Campbell, 110 F. Supp. 282 (S.D. Cal. 1953); Colby v. Klune, 178 F.2d 872 (2d Cir. 1949); *see also* Reliance Elec. Co. v. Emerson Elec. Co., 404 U.S. 418 (1972).

165 *See e.g.* Smolowe v. Delendo Corp., 136 F.2d 231 (2d Cir. 1943).

166 *See e.g.* W. PAINTER, *supra* note 51, ch. IV (treatment of partnerships); *but see e.g.* Feder v. Martin Marietta Corp., 406 F.2d 260 (2d Cir. 1968).

tial information or the plaintiff's good faith.[167] Liability for profit earned in less than six months is almost automatic. And while Canadian legislation has borrowed concepts from section 16(b), it has not followed the arbitrary nature or narrowness of scope to recover "short-swing" profits and to impose such liabilities.

It may be noted that section 16(b) has been criticized as a legislative control. Private enforcement of liabilities by persons who, because of the derivative remedy need not have been securityholders during the six-month period and the fact that attorney's fees are recoverable by the plaintiff have led to apparent champerty and maintenance.[168] With the importance and vitality of Rule 10b-5 under the 1934 Act, there has been a question of whether there is any theoretical foundation left for section 16(b).[169] Notwithstanding the criticisms, it appears that section 16(b) has severely curtailed a visible abuse with a bounty system.

On a literal reading, Rule 10b-5 was not meant to remedy abuses of insider trading. It is framed in criminal law terms and was conceived as a corresponding section to regulate purchases of securities since section 17 of the Securities Act of 1933 (hereinafter the 1933 Act)[170] had application only to sales of securities. There is no reference to nor directory language from which to infer that the rule was meant to regulate insiders. However, from the SEC's first consideration of the rule,[171] it was apparent that a wide scope of activity would be regulated with the implication that insider trading would also be covered.[172] In time, the rule has become the most important regulatory tool for insider trading, and interpretations of cases pursuant to the rule have become the model for other jurisdictions' sanctions.

Rule 10b-5 may be invoked in several ways. The SEC may bring administrative, criminal or equitable proceedings to enforce it.[173] From theories of statutory tort, voidability, implication and policy, private parties may bring action, either personally, as a class, or derivatively, against violators of the rule.[174] Therefore, the rule operates differently depending on the "plaintiff" and the

167 In this regard, the Kern case, *supra* note 163, represented a real departure in that the defendant's lack of access to information and the absence of potential for abuse absolved it of liability.

168 *See e.g.* KIMBER REPORT ¶ 2.28; 2 L. Loss at 1053.

169 *See* ALI FEDERAL SECURITIES CODE, Tent. Draft No. 2 (1973), s. 1413, comments (1), (2).

170 The said statute will be referred to hereinafter as the "1933 Act".

171 *See* Ward LaFrance Truck Corp., *supra* note 160.

172 *Id.*

173 1934 Act, ss. 21, 32.

174 *See* 1 A. BROMBERG, SECURITIES LAW: FRAUD - SEC RULE 10B-5, 27 (1977) [hereinafter cited as A. BROMBERG].

type of remedy being sought and, in reviewing the jurisprudence of the rule, the distinction as to who is the "plaintiff" is critical.

This source material for statutory insider trading liabilities lends itself to several preliminary observations. Insider liabilities are not straightforward homogeneous concepts. The foundation for the theory of liability is the fiduciary concept and, not surprisingly, the common law more readily recognized insider accountability to the company. But the fiduciary obligation does not lend itself so easily to an interpretation which would compensate the market or shareholders for losses. Therefore, fraud concepts and penal considerations of fair trading in securities markets have been adapted to regulate this type of behaviour. It is clear that insiders must serve many masters and be responsive to several theories of proper ethics.

2. *Affected Companies*

All Canadian legislation excepting the CBCA imposes statutory liabilities for insiders of "public" companies only.[175] The legislative concern to which the statutory liability provisions respond was not to override or vary the common law rules generally but only to do so for insider trading in selected widely-held companies. Therefore, shareholders of closely-held companies must resort to their common law remedies in order to assert liability. Statutory liabilities apply to a limited minority of companies in Canada notwithstanding that the facts giving rise to the common law decisions, for the most part, represented abuses in closely-held companies.[176]

Such a distinction between widely-held and closely-held companies applies with respect to section 16(b) of the 1934 Act but Rule 10b-5 has not been subjected to such a limited reading. The rule covers all companies, whether or not they have issued securities publicly and regardless of whether the transaction in question took place in a public market. As a matter of policy, when a complaint is prosecuted by the SEC, action will only be taken in respect of widely-held companies. However, since the first private action pursuant to Rule 10b-5, *Kardon v. National Gypsum Co.*[177] which involved private transactions in a closely-held company, the rule has been applied to any company. Unlike section 16(b) and most Canadian legislation, the rule has universal application.

175 *Compare* CBCA, s. 125 (using definition of "corporation" in CBCA s. 2(1)) with Canada Act, s. 100.4 (using definition of "insider of a company" in Canada Act, s. 100(1)).

176 *See e.g.* Percival v. Wright, *supra* note 104; Gadsden v. Bennetto, *supra* note 110.

177 73 F. Supp. 798 (E.D. Pa. 1946).

The CBCA, which heralded liabilities for insiders of closely-held companies, is a positive development. An insider of a closely-held company who avails himself of his position for advantage at the expense of his shareholders or affected purchasers or sellers will commit no less dishonourable an act than would the insider of a public company. To permit such behaviour in closely-held companies is inconsistent and there are no persuasive arguments to exempt insiders of closely-held companies from such standards. At best, it may be said that such a distinction is responsive to the penal considerations with insider trading in public markets but it would negate fiduciary and compensatory principles applicable to this area of conduct.

There may, however, be practical limitations on the broad imposition of insider trading liabilities to all companies. The constitutional basis from which the federal corporations law states that insiders of all corporations incorporated under that law are subject to certain liabilities is clear.[178] However, whether federal legislation can or should apply to all companies regardless of jurisdiction of incorporation and to cases which will involve purely local considerations raises a host of different considerations. Even in the United States, insider trading liabilities pursuant to section 16(b) preceded by several years the imposition by federal law of liabilities in closely-held companies in a purely local environment. If the considerations are purely remedial, insider liability should apply in all cases. If, however, there should develop a question of constitutional or policy priorities, the regulation of insider trading in closely-held provincially incorporated companies should be left to provincial law.

3. *Insiders for Liability Purposes*

Insiders who may be liable pursuant to the statutory liability provisions constitute a broader class of persons than those who are required to report. In the provincial statutes, "associates", "affiliates" and, in corporations statutes which permit a company to buy its own shares, the company itself may be held responsible. The Canada Act extends potential liability to persons employed or retained by the company and its auditor. These legislative provisions attempt to identify specific persons for purposes of liability. But, while this designation is responsive to a theory of accountability for corporate office, it demonstrates a compromise with the view to certainty. It is clear that, regardless of the breadth of the statutory designation, such a list of persons will not embrace all

178 *See* most recently, *In re* Multiple Access Ltd., *supra* note 137.

who have access to or who may act on confidential information. Therefore, and by way of example, the Canada Act has broader application than the Ontario Securities Act but both statutes consider access as being synonymous with accountability for a specified corporate relationship. Liability does not extend to all who may misappropriate information but to specific persons who may do so.

The CBCA and Ontario Bill 30 have abandoned the concept of listed insiders for liability purposes.[179] However, before reviewing these new and proposed provisions for insider trading liability, it is useful to examine the jurisprudence pursuant to Rule 10b-5 which, to a great extent, has influenced Canadian legislative developments.

Rule 10b-5 applies to "every person" so that there is no express limitation governing who may violate the rule. However, there are a number of features of the rule itself indicating that there are practical limitations in the area of insider trading. First, the rule has much broader application than the regulation of insider trading and, for the most part, it is the references to non-disclosures of subclause (2) and the operation as a fraud or deceit in subclause (3) of the rule that have primary application to the subject. Second, the type of remedy sought will influence the scope of the phrase "every person". There is a distinction between proceedings to regulate fraudulent behaviour in the market, of which insider trading may be a part, by the SEC and those of a private plaintiff seeking compensation or rescission.[180] Therefore, although the rule has no express limitation as to who may be liable, that has not meant that every person, literally, may be liable for insider trading.

In the early years of enforcement of the rule, there was no substantial difference as to who might be liable on the basis of insider trading in SEC or private actions. The first Rule 10b-5 cases were limited to seeking recovery from primary insiders such as directors, officers and substantial shareholders.[181] It was not clear whether a private plaintiff could prove all the elements required to succeed in his private action if he attempted to hold a broader class of insiders liable.[182] In effect, until the decision in

179 CBCA, s. 125(1)(f); Ontario Bill 30, s. 133.

180 *Compare, In re* Cady, Roberts & Co., SEC, Securities Exchange Act of 1934 Release No. 6668, November 8, 1961, 40 SEC 907 (1961) *with* Ross v. Licht, 263 F. Supp. 395 (S.D.N.Y. 1967).

181 *See e.g.* H. Manne, *supra* note 3, ch. 3.

182 *See* discussion of "privity" and "reliance" in text *infra*.

Cady, Roberts & Co.,[183] insider liabilities pursuant to Rule 10b-5 paralleled section 16(b) in terms of who might be liable.

Cady, Roberts was an SEC disciplinary proceeding for violations of section 10(b) of the 1934 Act and section 17(a) of the 1933 Act. A registered representative of the broker, *Cady, Roberts*, was a director of a public issuer and the price of the issuer's securities had been rising. During a recess of a meeting of the issuer's board at which the quarterly dividend was reduced, the *Cady, Roberts* representative notified a partner of his firm of the reduction. The issuer's securities were sold for various customers and several short sales were effected before news of the dividend reduction first appeared on the Dow Jones service. The SEC found that *Cady, Roberts* had committed a violation but it did not proceed further against the broker or its registered representative. The partner was suspended from trading on the New York Stock Exchange for twenty days.

Cady, Roberts was the first major pronouncement of an actual "access test" for insider trading liability. Chairman Cary stated:

> "Analytically, the obligation [of insiders] rests on two principal elements; first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing."[184]

However, this actual "access test" was enunciated in a disciplinary proceeding, one of the SEC's functions in the general administrative regulation of fraud in the securities market, and there remained the issue of whether a similar result could be expected in court proceedings and for purposes of civil liability.

Ross v. Licht[185] involved the first consideration of an actual "access test" in a civil action. The company was closely-held and, in anticipation of an offering of shares to the public at a higher price, its officers and directors as well as the remaining substantial (but not 10%) shareholder employees and their friends purchased the plaintiff's shares. In an action pursuant to Rule 10b-5, the court stated:

> "[Two defendants] were substantial stockholders and responsible employees of National and as such learned of the proposed private and public offerings.... In determin-

183 *In re* Cady, Roberts & Co., *supra* note 180.
184 *Id.* at 912.
185 Ross v. Licht, *supra* note 180.

> ing whether a person, not a director or officer, is a corporate insider...the test is whether he had such a relationship to the corporation that he had access to information which should be used only for a corporate purpose and not for the benefit of anyone."[186]

Furthermore:

> "If...[three defendants] were not insiders, they would seem to have been 'tippees' (persons given information by insiders in breach of trust) and subject to the same duty as insiders....And in any event...[they] would be equally liable for aiding and abetting a violation of Rule 10b-5."[187]

The court proceeded to hold the defendants liable in damages.

The paramount decisions on the issue of an actual "access test" were the landmark cases of *SEC v. Texas Gulf Sulphur Co.* (TGS).[188] This case involving insider trading before public announcement of a significant mineral discovery endorsed the *Cady, Roberts* view that "anyone who, trading for his own account in the securities of a corporation has 'access, directly or indirectly...' " was subject to Rule 10b-5. A company engineer, the chief geologist, another geologist and an attorney were censured. A determination of a geologist's liability for "tipping" was requested and he was held liable for "tippee's" profits.[189] On the question of the "tippee's" liability, the court's *dicta* indicated that tippee trading was as reprehensible as trading by other insiders.[190] The appellate court's decision in TGS completed the analysis of who should be liable pursuant to Rule 10b-5.

This conclusion of who should be liable for insider trading constituted important extensions in traditional thinking on insider trading. An actual access approach to liability replaced any formulation of a mechanical and, by definition, futile attempt to designate relationships that give rise to obligations and liabilities. A person did not have to hold office or influence with the company in order to be accountable to the market. Determinations of liability would have to change from an emphasis on the identity of the trader to the broader context of the nature and source of his information. For these reasons, there was a justifiably broad and ambivalent reaction to the expanded scope of liability.[191]

186 *Id.* at 409.
187 *Id.* at 410.
188 258 F. Supp. 262 (S.D.N.Y. 1966), *rev'd*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).
189 401 F.2d at 843; *see also* SEC v. Texas Gulf Sulphur Co. (No. 2), 312 F. Supp. 77, 95 (S.D.N.Y. 1970) (on remand).
190 SEC v. Texas Gulf Sulphur Co., 401 F.2d at 852, 853.
191 *See e.g.* H. Manne, *supra* note 3, at 45.

This actual "access test" for liability raised important corollary issues. Should the conveyor of information, the "tipper", be liable for trading losses of others or trading profits which he does not realize personally?[192] Does the mere fact that confidential information is conveyed give rise to liability or must there be trading profits before an offence is committed by the "tipper" or "tippee"?[193] If there are trading profits, how should the "tipper" and "tippee" share liability and to whom should recovery be permitted?[194] What are the obligations of the "tipper" and "tippee" as between themselves?[195] There are obvious implications with what is a simple conceptual refinement in the focus of liability.

The most important issue raised by the actual access test is the question of what insider trading would be following removal of specific designations for liability. Traditionally, insider trading and the liability which is extended therefrom is the trading in securities of a company by a person who has a relationship to the company. He owes a duty and, if he breaches that duty, he should be liable. Colloquially, the law will protect against the person "on the inside" who takes advantage of those "on the outside" to whom he owes a duty of good faith. With application of the actual access test, the relationship to the company may be blurred and, on the basis of access and a qualitative valuation of the information, there could be liability. What remains of liability on the basis of relationship to the company? The SEC[196] has leaned towards extending liability with emphasis on whether the information was generally known. It appears that the source of the information or relationship is becoming less important when imposition of more general standards in the trading of securities is at issue. Commentators in the United States[197] have urged retention of the relationship aspect before insider liability is imposed in civil cases in that the offending trader should know that the information emanated from a corporate source. Liability in this latter case is clearly based

192 *See e.g. In re* Investors Management Co. Inc., SEC, Administrative Proceeding File No. 3-1680, June 26, 1970, [1969-1970 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,832; *see also* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 353 F. Supp. 264 (S.D.N.Y. 1972), *aff'd*, 495 F.2d 228 (2d Cir. 1974).

193 *See e.g.* Financial Industrial Fund Inc. v. McDonnell Douglas Corp., 315 F. Supp. 42 (D. Colo. 1970); *In re* Fabergé Inc., SEC, Securities Exchange Act of 1934 Release No. 10174, May 25, 1973, [1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 79,378.

194 *See e.g.* Nathanson v. Weis, Voisin, Cannon Inc., 325 F. Supp. 50 (S.D.N.Y. 1971).

195 *See e.g.* James v. DuBreuil, 500 F.2d 155 (5th Cir. 1974); Kuehnert v. Texstar Corp., 412 F.2d 700 (5th Cir. 1969); Wohl v. Blair & Co., [1969-1970 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 92,619 (S.D.N.Y. 1970).

196 *See e.g. In re* Investors Management Co. Inc., *supra* note 192; *In re* Fabergé Inc., *supra* note 193.

197 *See e.g.* ALI Federal Securities Code, Tent. Draft No. 2 (1973), s. 1303(b)(4) and comments.

on "insider" trading. This issue has not been resolved fully in the United States.[198]

Against this background, the CBCA and Ontario Bill 30 expanded the scope of who might be liable for insider trading. The CBCA included "a person who receives specific confidential information from...[another insider]...and who has knowledge that the person giving the information is...[another insider]".[199] In effect, "tippees and sub-tippees" are included in the definition of insider. Ontario Bill 30, adopting the more general approach from the SEC's interpretation of Rule 10b-5, refers to "every person or company...with knowledge of a material change with respect to the responding issuer...".[200] In addition, the regulatory authority would receive the power to sanction insider trading directly in the Ontario Bill.[201] However, neither of these two extensions of liability have responded to all of the issues raised by the actual "access test".

In the case of Ontario Bill 30, there are a number of technical difficulties. For purposes of civil liability, a person is liable to compensate a purchaser or vendor of such securities if the person has knowledge of "a material change with respect to such issuer". However, for purposes of penal sanction, a person may not "purchase or sell securities of a reporting issuer with knowledge of a material change in the affairs of the reporting issuer".[202] This deviation in wording may lead to the strange conclusion that, for purposes of criminal liability the material change must be from a corporate source since it must be related to the affairs of the issuer whereas, in the case of civil liability, any material change with respect to the issuer will be sufficient. In effect, the drafting may not respond clearly to liability founded on fiduciary concepts as compared to that which is founded from the desire to maintain fair dealing in markets generally. There is doubt, therefore, as to how "market information" would be treated under the new legislation.[203] Basic questions as to the liability of the "tipper" as opposed to the "tippee" are not answered.[204] There is no attempt to deal with the problem of the financial institution described as having

198 *See e.g.* Zweig v. The Hearst Corp., [1975-1976 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 95,391 (D.C. Cal. 1975).

199 CBCA, s. 125(1)(f).

200 Ontario Bill 30, s. 133(1).

201 *Id.* s. 77.

202 *Id.* ss. 77, 133(1).

203 "Market Information" is information affecting the market for the company's securities but not necessarily the company itself; *see* Fleischer, Mundheim & Murphy, *An Initial Inquiry into the Responsibility to Disclose Market Information*, 121 U. Pa. L. Rev. 798 (1973).

204 Note that Ontario Bill 30, s. 133(1), includes "tippers" but the measure of damages provisions in s. 133(5) draws no distinction between traders and "tippers".

"Chinese walls".[205] Ontario Bill 30 has made progress in adopting new theories of liability but there are serious questions of interpretation which must be resolved.

In the case of the CBCA, there are similar questions of interpretation. The definition of "insider" contains a number of redundancies with the result that there may be significant questions in the future.[206] While there is no question concerning the source of the information, and it is relatively clear that "market information" is not contemplated, a "tippee" is accountable to the company notwithstanding that he has no immediate fiduciary relationship from which liability should be founded.[207] Reconsideration of the CBCA provisions would be helpful.

An actual access test would be preferable to designation of specific individuals for liability purposes but clear delineations of sources of liability are essential. A response to the fiduciary considerations underlying insider trading liabilities would require that a corporate source for the confidential information be the foundation for liability. "Market information" would not be treated as a source for insider abuse. However, since the abuse follows dissemination of confidential information, it should be clear that an "insider" need not trade before liability is imposed. A "tipper" could therefore be more responsible than a "tippee" since the "tipper" may be the fiduciary. Recovery by the company should be limited to primary insiders in order to preserve the theory of accountability from fiduciaries. This would also mean that, in the case of the company, it would only have recourse against the "tipper" and the "tipper" could, in any case, pursue his remedies against his "tippee". In the case of actions for compensation, there is much to be said for preserving fiduciary principles of accountability as the primary basis for liability.

Insider trading standards and fiduciary principles coalesce, to a great extent, with responses to the need for fair and orderly securities markets. Remedial measures which are based on penal considerations should not be limited by requirements of demonstration of fiduciary connection. The CBCA, which requires a corporate source and correctly traces fiduciary standards as a basis for liability, would not extend far enough for purposes of general market regulation. Ontario Bill 30 is too general and will invite narrow interpretations by the courts of both insider trading and more general market regulation cases. The difficulty, typified by the treatment of "market information" cases, stems from the

205 *See e.g.* Miller, *Chinese Walls*, 8 Rev. Sec. Reg. 865 (1975).
206 *See e.g. Anisman* at 215.
207 CBCA, s. 125(5)(b).

need to delineate insider trading and market regulation liabilities more precisely.

It is suggested that, under the subject of insider trading, the persons who should be liable would be those prescribed by a refined definition along the lines of the CBCA.[208] Issues such as market information and absence of an insider source for confidential information should be the subject of regulation under a separate heading.[209]

4. *Connection with a Transaction*

All of the statutes which regulate insider trading impose liability "in connection with a transaction" and there is a significant question as to the scope of liability that is contemplated. Under the Canada Act, it is "a transaction relating to the securities of the company" and the CBCA states that it is "a transaction in a security of the corporation or any of its affiliates". Clearly, purchases or sales by insiders are embraced by the legislative provisions. However, it is not clear whether the expression does not extend liability further.

Consider, for example, a profitable purchase and sale effected by a friend of an insider with the assistance of confidential information from the insider. The friend's transaction, quite clearly, qualifies for "in connection with *a* transaction" and the friend's profit may result in the insider's "own benefit or advantage" if a favour is owed or given in return. It can also be argued that this is the very type of behaviour that the legislation was meant to remedy. If such a case were made, the insider's exposure is, at best, unclear and the statute would appear to indicate that "tipper" liability is possible.

The CBCA's slight variation to the connection requirement to include the securities of affiliated companies becomes more meaningful. A broader category of transactions is contemplated in that, for questionable dealings in an affiliate's securities, the rights of an affiliate's shareholders are extended to the company's shareholders. One obvious interpretation would give the shareholder of a parent company the right to bring action against a "tippee" of a subsidiary's insider for a trade in the subsidiary's securities. With the extended definition of insiders who may be liable, the broader connection requirement becomes significant.

Ontario Bill 30 has clarified the connection requirement by contracting the scope of potential liability to apply only to the

208 The definition of s. 125 could have deleted all except subsections 125(1), (2), (3), (4).
209 In this respect, Ontario Bill 30, s. 77, would be a convenient beginning.

company but expanding potential liability to include "tippers". In the section on civil liability, section 133, the person must sell, purchase or inform the vendor or purchaser about securities of the reporting issuer. There is no express extension to transactions in affiliated company securities. For purposes of criminal and other public liabilities, in section 77, the prohibition applies to purchases, sales and informing about securities of a reporting issuer. In this latter case, the expression "purchase or sell" has replaced earlier wording which used "trade".[210] Ontario Bill 30 represents a significant departure from federal legislation and possible interpretations of existing legislation in the provinces.

The transaction test appears to have borrowed from similar wording in Rule 10b-5 and it is instructive to examine the U.S. experience with the phrase "in connection with the purchase or sale". The phrase has been interpreted often since plaintiffs in private actions, wishing to avail themselves of the advantages of a hearing in a federal court where broader liabilities on the basis of "fraud" may be extended, must demonstrate "connection" as a jurisdictional matter. In that regard, Professor A. Bromberg has stated that:

> "The 10b-5 requirement of 'connection' between misconduct and a security transaction ...presents no obstacle to litigating conflict transactions consisting of (1) securities trades between the company and insiders ...or (2) mergers or similar transactions on unfair terms for minority shareholders. These are security purchases or sales and the misconduct is ultimately related to them. But the 'connection' problem does arise, e.g., when the conflict transaction is not itself a security transaction but is in some way related to one."[211]

The two types of cases which are of interest for comparative purposes are, first, the type of "connection" from the point of view of remoteness before the rule may be invoked and, second, whether the plaintiff must be a purchaser or seller of securities in order to avail himself of the rule.

Initially, federal courts were reluctant to broadly interpret the word "connection" in their consideration of transactions since the result of seeking expansive jurisdiction could be controls beyond the scope of conduct the legislative censure was meant to cover.[212] More recently, the courts have acknowledged jurisdiction in a broader number of instances and, for example, transac-

210 *See e.g.* Ontario Bill 75, ss. 1(36), 74.

211 1 A. Bromberg, *supra* note 174, at 88.1.

212 *See e.g.* Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir. 1952).

tions in securities of affiliated companies indicated sufficient "connection" for purposes of liability.[213] "Tipper" liability has also been imposed on this basis.[214] The Supreme Court, in its unanimous decision in *Sup't of Insurance v. Bankers Life & Casualty Co.*[215] suggested that the "connection" could be tenuous and, as a synonym, used the word "touching".[216] The Court did not, however, explicitly state what the connection requirement should be. It is clear that "connection" will be liberally construed but the exact scope is unclear.

On the issue of whether the complainant had to have been a purchaser or seller, the courts have recently retreated. The original formulations of liability were careful to restrict application of the rule for recovery only to purchasers or sellers and to reject any opportunity to police corporate mismanagement.[217] The erosion of this strict rule became apparent in derivative actions, in cases involving broad interpretations of the type of transaction to be covered and in instances where liberal interpretation of the causal connection of the loss before and after the misconduct assisted in making the "connection".[218] However, the reluctance to compensate if the complainant was not involved in any transaction or if the only transaction turned out to be abortive followed the more historical view with two recent cases in the Supreme Court of the United States.[219] It is clear that the complainant had to have been a purchaser or seller of securities.

The "connection" requirement is still a much more important issue in the United States than Canada. In the United States, the issue is closely linked to questions of jurisdiction and standing to bring action quite apart from the considerations of remoteness which are common to both jurisdictions. However, the resolution of the question of remoteness in the United States provides examples of the issues which may have to be considered in Canada under applicable legislation. For example, a sale of shares at a premium

213 *See e.g.* Schoenbaum v. Firstbrook, 405 F.2d 215 (2d Cir. 1968).

214 *See e.g. In re* Investors Management Co. Inc., *supra* note 192; Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, *supra* note 192.

215 404 U.S. 6 (1971).

216 *Id.* at 12, 13.

217 *See e.g.* Birnbaum v. Newport Steel Corp., *supra* note 212.

218 *See e.g.* James v. Gerber Food Products Co., 483 F.2d 944 (6th Cir. 1973); Crane Co. v. Westinghouse Air Brake Co., 419 F.2d 787 (2d Cir. 1969); Vine v. Beneficial Fin. Co., 374 F.2d 627 (2d Cir. 1967), *cert. denied*, 389 U.S. 970 (1967); Hooper v. Mountain States Sec. Corp., 282 F.2d 195 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1960).

219 In Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975), the Court unequivocally required that the plaintiff be a purchaser or seller to have standing; shortly thereafter, in Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), the Court's finding with respect to scienter, discussed *infra*, indicated a further trend to restrictive interpretation.

by insiders such as took place in the *Farnham* case in Canada may be litigated pursuant to statutory insider trading provisions in the future.[220] As a result, the experience of the United States sheds light on the type of fact situations which give rise to causes of action and should be considered notwithstanding the impression that the cases relate primarily to jurisdiction.[221]

The lack of jurisprudence under the Canadian provisions requiring a transaction underscores the vagueness of the provision and the interpretation problems which may be expected. Courts may very well choose a narrow transaction test, as is suggested in Ontario Bill 30, whereby the insider must be the purchaser, seller or "tipper" in respect of the issuer's securities. A more expansive approach, even under the older legislation, could result in, for example, liability for inducing not to trade or to trade in holding-company shares or not to require the complainant to have been a purchaser or seller of securities. It would be helpful if the legislative provisions were clarified.

Ontario Bill 30 has indicated one approach at clarification. By limiting the scope of the liability to transactions of or "informing" by the insider in securities of the company only, the legislation has emphasized the insider's accountability to the corporation for actual transactions in its securities. As such, it appears that the vibrancy of the immediate fiduciary relationship is preserved and the only outstanding questions become whether an actual transaction should be so critical and whether the complainant must have been the purchaser or seller of those securities if, for example, he was induced not to trade. It is difficult to justify a restriction to transactions in the issuer's securities only and it would be a narrow obligation indeed if an insider could avoid fiduciary obligations by trading in the securities of an affiliated company or by inducing inactivity. Similarly, it is an arbitrary liability which imposes obligations on a "tipper" and "tippee" of confidential information without resolving how they are to share liability. The attempt to clarify falls short.

The connection requirement should vary with the type of remedy being sought. In the case of public sanctions for purely remedial purposes, there is no immediate need for a transaction test as such. Misrepresentations or concealments by insiders may and should give rise to remedies whether or not the insider trades or "informs" in connection with actual trades. There will be aggrieved parties. For purposes of civil liability, the considerations would be different. Ontario Bill 30 which requires the complainant

220 Indeed Farnham, *supra* note 136, is similar to Birnbaum, *supra* note 212.
221 *See* 1 A. Bromberg, *supra* note 174, at 87.

to have been a purchaser or seller of securities of the company is too narrow. There should be liability where an insider induces trades or maintenance of a position and this should apply in cases of the issuer's as well as affiliated company's securities. There should be a "connection" to a trade for civil liability purposes but the connection should be established if the transaction or inducement took place in securities of the company or affiliates and, in any case, where the insider had a hand in the course of dealings which ultimately took place. This would be consistent with an insider's fiduciary obligations and the courts should adequately restrict against undue remoteness. The insider would have a higher standard for purposes of public sanctions and one which is only slightly reduced for civil liability purposes.

5. *Making Use of Specific Confidential Information*

Each of the Canadian statutes provides that the insider must "make use of...specific confidential information" as a basis for liability and this phrase raises a number of issues for resolution. What constitutes "making use"? How will the courts interpret the phrase "specific confidential information"? This phrase in the legislation outlines the offensive behaviour of the insider which must be proved.

An insider will "make use" of information if his knowledge of the information motivates him to trade with the benefit of that information. The narrowest interpretation of the phrase would require proof of the insider's knowledge of the information, his motivation by and reliance on such facts and his resulting trade. Such a view, drawing strongly from the penal considerations attendant with insider trading, has been looked on favourably by the courts in *Green v. Charterhouse* and by the OSC where the notion of the insider's motive for profit was inferred from the phrase and emphasized.[222] If this narrow interpretation continues as the general view, the connection requirement outlined above will be reinforced, proof of scienter will have been imposed and it is only the insider's trades which will give rise to liability. As D. Johnston has pointed out, the entire behaviour pattern will have to be abusive.[223]

A narrow interpretation of "making use" is neither directed by the legislation nor would that be warranted. It would be an

222 Green v. Charterhouse Group Canada Ltd., *supra* note 111, [1973] 2 O.R. at 737 (H.C.); 12 O.R. (2d) at 307 (C.A.); *In re* Harold P. Connor, *supra* note 139 at 168; *see also*, *Anisman*, at 218, 222; Davies, *supra* note 6, at 231; Johnston, *supra* note 6, 51 Can. B. Rev. at 676; Johnston, *supra* note 6, 15 Western Ont. L. Rev. at 241.

223 Johnston, *supra* note 6, 51 Can. B. Rev. at 686.

onerous requirement indeed that would provide for an aggrieved party to evaluate and prove the varying and perhaps numerous motivations of an insider. Similarly, such a requirement gives little weight to the compensatory considerations which should stand with at least the same importance as the penal. The wording of the statute, in stating that it is "in connection with a transaction" and in not directing a specific use permits the inference that "making use" was not intended to apply in the most or in a particularly limited sense.[224] In providing for a means of statutory compensation, the legislation should not be read as providing a narrow quasi-criminal standard allowing for ready avoidance by insiders.

Ontario Bill 30 does not solve this interpretation question. The proposed section is framed to provide that a purchase, sale or informing by the insider gives rise to compensation as opposed to "making use" being the offensive behaviour; however, if the insider did not "make use" of the information, he has a defence.[225] Apart from begging the question of what constitutes "making use", this solution should be viewed with reference to the narrow "connection" requirement in Ontario Bill 30 described above. The issue is settled in Ontario Bill 30 by removing the question of remoteness to some extent, *i.e.*, avoiding inferences of liability for other than specific purchases or sales of the issuer's securities, and extending what may be an overly restrictive interpretation of "making use" by the courts. This will not assist potential plaintiffs.

United States federal regulation demonstrates how difficult interpretation of such a phrase can become. Under section 16(b) of the 1934 Act, the mechanical approach to liability did not raise significant obstacles to interpretation until recently when usage of information was considered.[226] Moreover, interpretations under Rule 10b-5, which is introduced with the phrase "use or employ", were the subject of increasingly liberal interpretations of what constituted use until recently.[227] United States courts appear to have come full circle from narrow to expansive and back to restrictive interpretations of the phrase. This trend to defendant-oriented conclusions appears to be inherent in the Canadian provisions.[228]

What constitutes "specific confidential information" may be a more difficult issue. The phrase itself, irrespective of the other

224 *See, Anisman* at 224.

225 Ontario Bill 30, s. 133. Essentially, this sanctions the Green v. Charterhouse interpretation.

226 *See* Kern, *supra* note 163.

227 *See* Ernst & Ernst v. Hochfelder, *supra* note 219; *see also* discussion of scienter, *infra*.

228 A good analysis of this U.S. trend may be found in Lowenfels, *Recent Supreme Court Decisions under the Federal Securities Laws*, 65 GEO. L.J. 891 (1977).

modifying features in the sections, gives rise to immediate concerns for insiders. Directors and officers are almost always in possession of "confidential" information about the issuer and it can be postulated that it is impossible to carry on a broadly based business keeping the market sufficiently apprised so that it is safe for them to trade. Even if the insider's only motivation was full disclosure so that he could trade, he would have difficulty generally determining the "specific confidential information" that could give rise to liability.

The decisions in *Green v. Charterhouse*[229] underscore the potential problems with scope of the phrase. The trial judge stated that "specific confidential information" consisted of information obtained as a result of the insider's access and which was acquired for corporate purposes.[230] Such a description emphasizes the fiduciary duty of the insider founding liability on the basis of accountability for corporate sourced information. On appeal, and by way of dictum, the court indicated that "specific confidential information" will likely be from a corporate source but need not necessarily be.[231] In effect, the appellate court opened the question of liability for "market information" [232] regardless of source thereby emphasizing penal and compensatory considerations somewhat at the expense of accountability. The question of access might be relegated to a means of avoiding remoteness. Such interpretations may be workable and reasonable in face-to-face transactions with insiders but the consequences are unclear and less precise in open market transactions.

The confidential information must be "specific". In *Green v. Charterhouse*, the issue of specificity was one of ripeness of the confidential information.[233] Were the merger discussions sufficiently advanced for purposes of determining specificity? The court, in rejecting the plaintiff's claim, indicated that specificity could be equated with the degree of development of the information. Presumably, the question of specificity will be raised in other cases of remoteness, and where the information is too general or of dubious materiality.[234]

The CBCA does not give assistance on the question of "specific

229 Green v. Charterhouse Group Canada Ltd., *supra* note 111.

230 [1973] 2 O.R. at 740, 741.

231 12 O.R. (2d) at 309.

232 *See, Anisman* at 226; Johnston, *supra* note 6, 15 Western Ont. L. Rev. at 244.

233 *Compare* trial judgment in Green v. Charterhouse Group Canada Ltd., *supra* note 111, [1973] 2 O.R. at 742 *with* appellate finding, *supra* note 111, 12 O.R. (2d) at 306-07.

234 Indeed by observing the self-evident fact that specific is the opposite of general, the Court of Appeal in Green v. Charterhouse begged the question; *see* material in note 232 *supra* for attempts at resolution.

confidential information" but the issue would be varied somewhat by Ontario Bill 30.[235] Any person trading "with knowledge of a material change" as opposed to "making use of any confidential information" will be liable. Of the two possible interpretations which the courts discussed in *Green v. Charterhouse* Ontario Bill 30 would choose to emphasize materiality at the expense of preserving corporate source as the basis for confidentiality. And the full implications of liability based on market information would soon become apparent. A marked change from liability based primarily on a theory of accountability to liability based on materiality to the market may be expected.

In United States federal regulation of insider trading, there is no concept of "specific confidential information" as such in either section 16(b) or Rule 10b-5 under the 1934 Act. A number of cases and commentators have offered examples which would and would not qualify for liability purposes.[236]

The phrase "making use of specific confidential information" has given rise to unusual reactions. Tribunals and legislative draftsmen have reacted against a wide meaning of the phrase "making use" while, contemporaneously, suggesting the broadest meaning for "specific confidential information".[237] The reverse should have been the case. The principal basis for the offence of insider trading is breach of duty and the theory of recovery is primarily one of accountability for position with a company. Any "use", regardless of motive, should give rise to liability. However, it is debatable whether "any" material information should be characterized the same way. The regulation of insider trading, as indicated above, is one aspect of regulation of behaviour in markets. If it is to be given status independent of the regulation of fraud and disclosure in the markets, it must be on the fiduciary and accountability levels of consideration. For these reasons, the "offence" of insider trading as such should occur when an insider makes any use of corporate source information.

6. *Materiality*

The CBCA requires the "specific confidential information" to be such as "might reasonably be expected to affect materially the value of the securities". This materiality test raises similar ques-

235 Ontario Bill 30, s. 133.

236 *See e.g.* Geller v. Transamerica Corp. (1934), 53 F. Supp. 625 (D. Del. 1943), *aff'd*, 151 F.2d 534 (3d Cir. 1945); SEC v. Geon Industries Inc., 381 F. Supp. 1063 (S.D.N.Y. 1974); Harnett v. Ryan Homes Inc., 496 F.2d 832 (3d Cir. 1974); Rochez Bros. Inc. v. Rhodes, 491 F.2d 402 (3d Cir. 1974).

237 *See* Farnham v. Fingold, *supra* note 136; Birnbaum v. Newport Steel Corp., *supra*

tions of interpretation with the absence of judicial consideration of the provision. The common law rule which is, in effect, that a fact is material if it would influence the ordinary person in making his investment decision[238] should be considered in light of the breadth of facts which investors at large or individual market actors would consider to be important. And whether the common law rule as to materiality is to be equated with that which "might reasonably be expected to affect materially the value of the securities" is a separate issue. There should normally be a difference between a "material fact" as such, and its impact or effects which are the conclusions contemplated by the statute. But there is even some question of whether the word "value" in the legislation, in the absence of being modified by the word "market", means the quoted price. The current materiality test should not give rise to problems in gross instances of insider abuse but the issue may be more difficult to resolve in practice when there is doubt as to whether the information will affect the price.

As an example, consider the facts of *Green v. Charterhouse.*[239] In this instance of non-disclosure of what became merger negotiations, the courts' primary concerns related to whether the fact of the impending transaction had matured sufficiently for the confidential information to be specific enough. But apart from the issue of specificity, what of materiality? The merger or a takeover would be material but the question of ripeness of the facts is an obvious further consideration. If the *Green* insiders had elected to disclose, how much and what should have been disclosed as being material with the attendant risk that, if the transaction had not proceeded, the misrepresentation of those insiders could have founded liability? The court in *Green* alluded to the plaintiff's experience as an investor[240] so that the lesson to be learned may be distinguishable on the facts in future cases. The *Green* case is not the best example but it does serve to illustrate some of the complexity raised by current standards which in any event, will be applied with the marked benefit of hindsight.

There has been no alteration to the materiality test in the CBCA but Ontario Bill 30 has attempted to clarify. At first glance, sections 77 and 133, by referring to "material change" with respect to the reporting issuer or its affairs, indicate emphasis on the

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note 212; Green v. Charterhouse, *supra* note 111, [1973] 2 O.R. at 740, 741 (H.C.); 12 O.R. (2d) at 309 (C.A.).

238 *See e.g.* Pigott v. Nesbitt Thomson & Co. Ltd., [1939] O.R. 66, 76 (C.A. 1938), *aff'd*, [1941] S.C.R. 520.

239 Green v. Charterhouse Group Canada Ltd., *supra* note 111.

240 *Id.*, [1973] 2 O.R. at 743 (H.C.).

materiality of the facts themselves as opposed to their probable effects. However, "material" has been defined in section 1(22) to include "that [which] would reasonably be expected to have a significant effect on the market price". Little progress on resolving interpretation questions has been made since, in effect, the only real change relates to that which "would" rather than "might" affect.[241] Indeed, Ontario Bill 30 has begged the question of what would constitute a "material change".

Consideration of the materiality issue in the United States pursuant to Rule 10b-5 and similar provisions where the issue is raised are instructive. In *Kardon v. National Gypsum Co.*,[242] the reference was to a fact which "would materially affect the judgment of the other party to the transaction". In *TGS*, a case involving judgments in the open market, emphasis was placed on the reasonable man's judgment which "include not only information disclosing the earnings and distributions of a company but also those facts which affect the probable future of the company and those which may affect the desire of investors to buy, sell or hold the company's securities".[243] On the other hand, in *Kohler v. Kohler Co.*[244] material facts were those "which would clearly affect 'investment judgment' " whereas in *Hafner v. Forest Laboratories, Inc.*,[245] "[m]ateriality must be judged in the last analysis by effect on market price". Quite apart from the question of whether the information must affect the investor or the price, in *Mills v. Electric Auto-Lite Co.* and *Affiliated Ute Citizens of Utah v. United States*, the courts looked to whether "the defect was of such a character that it *might* have been considered important".[246] More recently, in *TSC Industries v. Northway, Inc.*, the court looked to "if there is a substantial likelihood that a reasonable shareholder *would* consider it important".[247] While the statements of definition do tend to coalesce in most insider trading cases, the distinctions should be considered.[248]

The imprecision attending the concept of materiality in Canada, where there is a dearth of authority, and in the United States, with many examples, underscores the futility of trying to set an

241 This may be an attempt to settle an objective standard as opposed to a more subjective standard relying on speculation; *see* notes 243-47 *infra*.

242 *See* Kardon v. National Gypsum Co., *supra* note 177, at 800.

243 401 F.2d 833, 849 (2d Cir. 1968).

244 319 F.2d 634 (7th Cir. 1963); *see also* Myzel v. Fields, 386 F.2d 718, 734 (8th Cir. 1967).

245 345 F.2d 167, 171 (2d Cir. 1965).

246 Mills v. Electric Auto-Lite Co., 396 U.S. 375, 384 (1970); Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 153 (1972).

247 96 S. Ct. 2126 (1976).

248 Indeed, there is a trend to narrowing exposure to liability; *see* Lowenfels, *supra* note 228.

objective standard when there are so many subjective considerations. There may not be a single test of materiality which would apply in face-to-face dealings and in the open market and which would account for behaviour of all reasonable men. Furthermore, faced with an insider who has profited, it may be difficult for a court to state that facts were immaterial and, thereby, contradict empirical data of someone who has engaged in trading. And whether materiality is defined or not may become somewhat academic since it is difficult to postulate an example where a defence based on immateriality would succeed in absolving an insider. There may be no real substitute for a measure of imprecision and uncertainty and, therefore, there is no real reason to define materiality as such.

At the same time, the legislation can and should assist in questions of materiality. With heightened continuing disclosure standards for issuers, the insider should have rules to which, by analogy, he can refer for evaluating proposed conduct in the open market. Such standards, which should be based on factors like the size of the issuer, the nature of its business and outstanding securities, commercial and legal experience with information of this type, will contribute to determination of whether facts are material and will assist, if there is proper corporate disclosure, on questions of timing of the insider's transactions. In open market cases, the insider should be able to take comfort from reliance on a fact which, for purposes of disclosure by the company, was not material. In face-to-face dealings of an insider with others, legislation cannot assist as greatly since it would be difficult if not impossible for legislation to trace individual motivations. It should not really matter whether the information "might" or "would" have an effect and this area should remain imprecise for this reason. Legislation should assist by settling disclosure required of the company and, by implication, it would set standards for insider dealings.

There will, of course, remain questions for the insider to decide. His judgments as to ripeness of the information, its general relevance and price sensitivity, who he is dealing with if it is a private transaction and similar considerations will still be important. But notwithstanding that disputing materiality may be one of few assertable defences of an insider, there must remain flexibility in the legislation and for the arbiter of disputes where the insider always has the option not to trade.[249] It is conceded that the insider loses much of the benefit of favourable news and ability to cut losses with adverse information, especially for cases where

249 *See* 3 A. Bromberg, *supra* note 174, at 287.

the fact of insider trading may be material, but this is consistent with the fiduciary duties which the insider has undertaken. The risk attending the issue of materiality must remain with the insider.

Treatment of "market information" also shapes the materiality question. However, as has been the position above, the materiality of this type of information should not affect insider trading which is based on corporate sourced information.

7. *Causation*

There are a number of causation tests implicit in the insider liability sections of the Canada Act. The insider is liable to compensate for "any direct" loss which arises "as a result of" the transaction and is also accountable to the company for "any direct" benefit or advantage he receives "as a result of" such transaction. Establishing causal relationships may not appear to create problems unique to insider trading. However, the nature of causation required to be proved should raise peculiar interpretation questions in open market transactions.

In cases which ultimately proceed to trial and where liability must be quantified under the section, the following causation issues are evident. First, the court must decide the cause of "any" loss by determining what results the transaction may have had in a relatively broad market or the "transaction causation".[250] Second, the court should consider the "direct" loss itself or the "loss causation".[251] Third, the court may quantify the direct benefit that an insider receives or a form of "loss causation". Finally, there is the "transaction causation" which is to be accounted for in quantifying the benefit resulting from the insider's transaction in the market. It may be expected that a court will ultimately overcome the causal connections difficulties based on the purpose of the provision.[252] However, at present, the causation issues are not settled and there are significant doubts as to how the legislation will be interpreted.

The causation issue may be the most difficult question to be answered for purposes of determining civil liability for insider trading in public markets. In such transactions, their essence is that a shareholder makes an impersonal trade which will blend with many others in the market. How does the shareholder prove losses or results of the insider's transactions without matching all

250 The concepts of "loss causation" and "transaction causation" are described in detail in 1 A. Bromberg, *supra* note 174, at 86.1, 86.5 respectively.

251 *Id.* at 86.5.

252 Kimber Report ¶¶ 2.21, 2.24, 2.25.

transactions in a given period?[253] If causation must be proved by matching transactions, recovery may be based on the purely fortuitous event that the insider bought or sold the specific securities of the complainant. If matching of transactions will not be the rule, the insider may be liable for all transactions of a specified period with a result that there is almost unlimited liability and, in any event, liability for more than his profit. It may very well be that unless these causation tests give rise to no recovery, unless there is privity of contract, insider trading gives rise to unquantifiable liability.[254]

The concept of causation in the insider liabilities section is unfortunate. It is "neither fish nor fowl" in that analysis based on theories of accountability or compensation, tort or contract, will yield different and inconsistent results proceeding from different theories. Liability may be readily determined in face-to-face transactions where there are finite steps and no uncertainty cast by interpositioning of an open market. But the theory breaks down for the examples which were the primary concerns of the provisions, namely, stock exchange transactions.[255] It may be argued that the legislation should be given any of several constructions giving credence to the purpose of the provisions.[256] But no argument gives full weight to the express language.

The CBCA has adopted the language of the Canada Act on this point but there have been suggested changes in Ontario Bill 30. In respect of OSC remedies under section 77, there is no concept of causation. But civil liabilities pursuant to section 133 are based on compensation "for damages as a result of the trade". The company is entitled to recovery since specified insiders are "accountable to such issuer for any benefit or advantage" received by such insider. Ontario Bill 30 represents a constructive change to the concept of causation.

A court interpreting Ontario Bill 30 should not have the same difficulties as before. The courts are assisted by having to determine "damages" instead of "direct loss" so that there is significant flexibility for open market cases. They may determine the "result of such trade" in open market cases on the basis of subsection 133(5) and not look to causation.[257] However, in face-to-face transactions, there is a basis for compensation in excess of actual loss

253 *See* J. Williamson, Supp. at 361; Davies, *supra* note 6, at 232.

254 *See, Anisman* at 239.

255 *See* Downs, *supra* note 6, at 97.

256 *See, Anisman* at 234.

257 Ontario Bill 30, s. 133(5), states, unequivocally, a formula for damages in all cases. *Quaere* the equity of this solution if the "plaintiff" succeeds in mitigating his damages.

since "damages" may entail satisfaction of interests in excess of an out-of-pocket or restitution measure and subsection 133(5) would endorse that. In open market cases, there is the risk of unlimited liability. Actions by the company are clarified in that the causation test has been replaced with a strict accounting. But it is clear that not only double liability, to the market and to the company, is intended but that the insider's profit may constitute a small portion of the amount of his liability.

The question of causation has been considered pursuant to Rule 10b-5 but interpretations have varied with the nature of the relief sought. As the rule may be invoked for purposes of penal, administrative and civil relief, causation is only relevant for cases where direct compensation is sought. The SEC need not prove causation just as a plaintiff pursuing a class action or with derivative status need not prove causation.[258] Injunctive relief may be available without such proof and, subject to ultimate proof of his damages, a private plaintiff may obtain partial summary judgment on the issue of liability.[259] Therefore, in private actions for monetary recovery, a plaintiff must prove causation notwithstanding that the rule does not direct its proof.

There have been a number of cases where "loss causation" has been considered.[260] The plaintiff has had to prove his compensable loss and the connection between the defendant's breach of the rule and the plaintiff's loss. Cases which have proceeded to trial have followed general tort theories of damages, which will be discussed below, and there are interesting examples of connection of a breach of the rule and compensable loss to the company, shareholders and creditors.[261] U.S. courts have struggled with problems of remoteness,[262] it having been advantageous that the vast majority of cases have involved face-to-face dealings. In respect of "loss causation", the courts have taken a flexible approach.[263]

"Transaction causation", which responds to the impact of the insider's transaction, has been more difficult. In face-to-face transaction, "loss causation" and "transaction causation" have proven to be synonymous. The open market cases are more difficult, the most stringent view having been typified by *Barnett v. Anaconda Co.*[264] where the plaintiff had to prove his transaction would not have taken place but for the offensive behaviour. The

258 *See* 2 A. Bromberg, *supra* note 174, at 213; *see also* 1 A. Bromberg, *supra* note 174, at 86.4.

259 *Id.*

260 *Id.* at 86.1.

261 *Id.*

262 *Id.*

263 *Id.*

264 238 F. Supp. 766, 776 (S.D.N.Y. 1965).

more prevalent tests typified by *Laurenzano v. Einbender*[265] and *Globus Inc. v. Jaroff*[266] sought the "transactional function" and the "lesser or minimal causal nexus", respectively. These cases are not, incidentally, insider trading cases so that the scope for "transaction causation" in such cases is unclear.

Most courts that have considered causation have spoken in more general terms. For the most part, causation has been inferred, *i.e.*, "causation in fact",[267] without particular analysis as to the type or concept of causation. In permitting a private action based on a penal provision, the courts have used causation interchangeably with other elements of a private action for deceit, *i.e.*, synonymous with reliance,[268] privity[269] and scienter,[270] and with materiality.[271] This U.S. experience underlines the difficulty of a concept such as causation for insider trading cases and is helpful to highlight the concerns which Canadian courts may have.

The source of causation as an element of proof of insider liabilities is the underlying compensatory consideration. Were the sole theory of liability that of accountability, whether criminal or civil, it should not matter what loss was caused by the misrepresentation or non-disclosure nor would the results of the insider's trades be particularly relevant. The insider could account on the basis that the behaviour was wrongful *per se* and a penalty consisting of disgorging of profits should be imposed.[272] However, when compensation is considered, it can be argued that causation is the critical element because there is the risk of unjust enrichment, *i.e.*, the plaintiff that cannot prove a loss, or unlimited liability, since causation may be helpful to measure and restrict recovery of damages. The vibrancy of the concept of causation as a basis for insider liability is not that it is an element of wrongful behaviour but rather that it limits the scope of liability for ultimate recovery in civil actions.

It may be seen that maintenance of a causation test results in a price to be paid for limiting liability and preventing unjust enrichment in that much of the credibility to civil recovery for insider trading is lost. As indicated, in the absence of judicial

265 264 F. Supp. 356, 360 (E.D.N.Y. 1966).
266 226 F. Supp. 524, 530 (S.D.N.Y. 1967).
267 *See* Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 154 (1972).
268 *See e.g.* List v. Fashion Park Inc., 227 F. Supp. 906 (S.D.N.Y. 1964), *aff'd*, 364 F.2d 457 (2d Cir. 1965).
269 *See e.g.* Joseph v. Farnsworth Radio & Television Corp., 99 F. Supp. 701 (S.D.N.Y. 1951).
270 *See e.g.* Ernst & Ernst v. Hochfelder, *supra* note 219.
271 Affiliated Ute Citizens of Utah v. United States, *supra* note 267; List v. Fashion Park Inc., *supra* note 268.
272 Indeed, that is the theory of recovery by the company under Canadian legislation.

authority, it may be difficult for a plaintiff to prove "loss causation" in open market transactions and the weight to be given to "transaction causation" is an even more difficult issue for resolution. The risk in compensation actions is clearly with the party the litigation aims to assist. What is less clear is why activities of an insider which are considered offensive must give rise to this statutory tort theory for recovery. There are means to protect against unintended liability which do not have the impact of frustrating the purpose of the legislative provisions and which avoid the irony of recovery being denied notwithstanding proof of improper insider trading. Equities can be maintained without causation as an element to be proved before recovery.

Assuming that the insider has traded improvidently and thereby triggered a measure of accountability, what should an aggrieved plaintiff be required to prove? In the open market examples, a plaintiff should only be required to prove that he traded the company's securities contemporaneously. If causation need not be proved, the plaintiff does not attempt to match transactions for "loss causation" nor does the result of the insider's trade become material. The insider's trades alone are the basis for the recovery. There is no unjust enrichment for the plaintiff since it should be presumed he would have acted differently had he the insider's knowledge at the time the trade was effected. The risk of unlimited liability is real but this should be answered below under "Measure of Damages". Removal of the causation requirement has the effect of emphasizing the penal considerations and the theory of an insider's accountability for insider trading, reducing the risk of proof to parties the legislation is trying to protect and characterizing the offensive behaviour as other than classical tort or contract examples for purposes of remedy.

8. *Scienter, Privity and Reliance*

The statutory remedies for insider trading do not expressly require a plaintiff to prove any of scienter, privity or reliance. However, the wording of the legislative provisions indicates that these concepts remain relevant for insider liability questions. Consider the tippee's knowledge of the source of information in the CBCA as an example of scienter, or the plaintiff's knowledge being a bar to recovery in the Canada Act as an example of reliance, or the causation questions discussed above when there is no privity. It may be expected that courts will consider these concepts in Canada as they have in the United States where Rule 10b-5 also makes no express reference to privity, scienter or reliance. Commenting on whether and how these elements of an

action must be proved in the United States, L. Loss reminds that "all that glitters is not gold"[273] and A. Bromberg that "[i]n practice they have all been balled up together".[274] The Canadian attempt to define a scope for liability shows that it will be helpful if not necessary to prove scienter, privity and reliance.

a. *Scienter*

While Canadian legislation and proposals to amend it do not require a positive intention to deceive, there are inferences of scienter that may be drawn. In the Canada Act, there is the connection of making use for the insider's benefit or advantage or what may be the intent to make a profit. This continues in the CBCA and, in the case of tippees, the person must know the source of the confidential information to be from another insider. Ontario Bill 30 permits a defence of good faith where the insider "had reasonable grounds to believe that...the material change had been generally disclosed" or that "he did not make use of" the information.[275] The courts and the OSC have clearly looked to the motivation of the insider when he traded.[276] It is apparent that more than wilful acts of the insider will be required.

In the United States pursuant to Rule 10b-5, the scienter requirement for SEC and related proceedings was typified by the finding in *SEC v. Capital Gains Research Bureau, Inc.*[277] where it was stated that:

> "Failure to disclose material facts must be deemed fraud or deceit within the intended meaning for...the darkness and ignorance of commercial secrecy are the conditions upon which predatory practices best thrive. To impose upon the Securities and Exchange Commission the burden of showing deliberate dishonesty as a condition precedent to protecting investors through the prophylaxis of disclosure would effectively nullify the protective purposes of the statute."[278]

The SEC did not need to prove intent to deceive or even wilfulness since a finding that the defendants were negligent will support enforcement or injunctive relief. And if negligence was sufficient, the primary issues for consideration were the defendant's good faith and his standards of care.[279]

273 3 L. Loss at 1765.
274 2 A. Bromberg, *supra* note 174, at 195.
275 Ontario Bill 30, s. 133.
276 *See* material cited in note 222 *supra*.
277 375 U.S. 180 (1963).
278 *Id.* at 193.
279 *See*, A. Bromberg, *supra* note 174, at 204, 211.

In compensation actions, the U.S. courts were somewhat divided. One line of cases typified by *Fischman v. Raytheon Mfg. Co.*[280] supported the contention that Rule 10b-5 should not be interpreted more broadly than other anti-fraud provisions such as sections 11 and 12(2) of the 1933 Act. Therefore, the defendant must not exhibit intention as required to support common law deceit but there must be a finding of fault, wilfulness or recklessness. Another group of cases typified by *Ellis v. Carter*[281] would have been more lenient to the plaintiff and almost mirror the SEC proceedings standard. The scienter standard to be applied appeared to vary with the circuit in which the case was litigated.

Two recent cases in the Supreme Court have both settled and reaffirmed the scienter requirement. In *Ernst & Ernst v. Hochfelder* and *Santa Fe Industries v. Green*[282] the court has unequivocally stated that, having regard to the history and purpose of the provision, proof of scienter is required to succeed in private actions under Rule 10b-5.[283] This standard has been followed in an SEC injunctive proceeding.[284] While the spectrum between a positive intent to deceive and recklessness remains open, it is clear that negligence will not suffice, at least for private actions.[285]

It is difficult to consider the question of scienter in the abstract or independent of the facts of a particular case. While it is theoretically possible that an insider's trade was effected in circumstances where there is no blameworthiness, *i.e.*, a pledgee of shares realizing on the insider's posted security, the usual case involves a wilful act with intent to profit. The insider's motivation, intention or other knowledge is academic where a regulatory body seeking to protect the public or a plaintiff seeking compensation can show the insider's relatively better position because of certain trades when compared to the rest of the market holding or having disposed of those securities. Similarly, scienter may be inferred in cases where the plaintiff can show causation or reliance and the materiality of the information upon which the insider relies often characterizes the insider's intentions. One is left with the conclusion that there may be room for a scienter standard in insider trading cases but that, for the most part, it is an artificial issue to be viewed with suspicion.

The standard of scienter that should be imposed should be

280 188 F.2d 783 (2d Cir. 1951).

281 291 F.2d 270 (9th Cir. 1961).

282 Ernst & Ernst v. Hochfelder, *supra* note 219; Santa Fe Industries v. Green, *supra* note 163.

283 *See e.g.* 425 U.S. 185, 207 (1976).

284 *See e.g.* SEC v. Bausch & Lomb Inc., 420 F. Supp. 1226 (S.D.N.Y. 1976).

285 Ernst & Ernst v. Hochfelder, *supra* note 219; Santa Fe Industries v. Green, *supra* note 163.

minimal varying, if at all, with the nature of the sanction to be imposed and, in any case, an element which the insider should be required to prove. Wilfulness, in the sense that involuntary trades or behaviour may be an exception, should be the initial consideration for compensation actions. But proceedings of a regulatory body should be judged by a negligence standard. If any party to the litigation must prove scienter, it should be the insider and there may be the unusual case where a transaction is not wilful and should not give rise to liability for compensation. Based on considerations of accountability and maintenance of fairness in the market, there is really no justification for absolution if the insider had other motives or failed to see all the consequences of his acts.[286] It would be inconsistent with the purpose of the remedial measures to require proof of intention or motive and legislation should not permit the inference that proof of scienter is required.

b. *Privity*

The inference that privity between the insider and the plaintiff seeking compensation will be helpful if not required in order to succeed in insider trading actions has been discussed, for the most part, under "Causation" above. To repeat, it would be difficult to demonstrate causal connections as contemplated by the legislation if there is no privity. But this question has been settled in Rule 10b-5 actions in the United States. In 1961, L. Loss stated that "[T]wo cases in the Second Circuit give pause, but may not be conclusive"[287] on the issue of privity. By 1969, he was able to state that "[T]wo cases in the Second Circuit...give pause, but quite clearly – one may now say – are not conclusive".[288] These references to "a semblance of privity" as suggested in *Joseph v. Farnsworth Radio & Television Corp.*[289] and to the fact that Rule 10b-5 "extended protection only to the defrauded purchaser or seller" in *Birnbaum v. Newport Steel Corp.*[290] have become historical to the point where "[p]rivity has become so unimportant that it is rarely mentioned".[291] It is hoped that Canadian courts would reach the same conclusions.[292]

Canadian legislation should not permit an inference that proof of privity be required and the risk that this artificial barrier

286 In this regard, the statement by the Court of Appeal in Green v. Charterhouse Group Canada Ltd., *supra* note 111, 12 O.R. (2d) at 307, that confidential information was "a factor" instead of "the factor" in the decision to trade is not helpful.

287 3 L. Loss at 1967.

288 6 L. Loss at 3890.

289 Joseph v. Farnsworth Radio & Television Corp., *supra* note 269.

290 Birnbaum v. Newport Steel Corp., *supra* note 212, at 464.

291 2 A. Bromberg, *supra* note 174, at 208.1.

292 *See*, however, materials cited in notes 253, 255, 256 *supra*.

be raised. It is fundamental to the regulation of an impersonal market that no prospective claimant be required to match his transactions, much less on the purely fortuitous basis that they correspond with an insider's. Removal of strict causation requirements will assist in the destruction of the privity concept in securities legislation. The only consideration of privity must be supplemental, for example, to assist in showing scienter, reliance, measuring damages. If that is the case, courts will not hesitate in giving credence to the statutory purpose.

c. *Reliance*

The inference in Canadian legislation and in *Green v. Charterhouse*[293] that a plaintiff will be required to prove reliance is disturbing in light of the U.S. experience with this deceit concept. Reliance has not been particularly relevant in SEC proceedings but it has been helpful if the market did or might have relied on actions of insiders.[294] In private compensation actions, it has been assumed that proof of reliance is a prerequisite to recovery.[295]

From the first private action under Rule 10b-5, courts sought to read in the need for a finding of reliance. While it was not a primary issue, in *Kardon v. National Gypsum Co.*,[296] the court found expressly that the plaintiff had relied on the defendant's conduct in the sale of the securities. In one of the leading cases, *List v. Fashion Park, Inc.*,[297] where the plaintiff sold his shares to a director who allegedly knew of a pending sale of the company and who resold the shares at a substantial profit, the plaintiff, an "experienced and successful investor" failed in the action. The court found that the purchaser of the shares had not availed himself of confidential information and that the plaintiff had not relied on the defendant's conduct for purposes of the sale. On the issue of reliance, the court was not convinced that the plaintiff would not have sold had he possessed the information allegedly known by the defendant and "[T]he proper test is whether the plaintiff would have been influenced to act differently than he did act if the defendant had disclosed to him the undisclosed fact".[298]

While the U.S. courts have regularly stated that some form of reliance is necessary for civil recovery, the exact scope contemplated is difficult to determine. In cases of non-disclosure, which

293 Green v. Charterhouse Group Canada Ltd., *supra* note 111, 12 O.R. (2d) at 743 (C.A.).
294 SEC v. Texas Gulf Sulphur Co., *supra* note 188; SEC v. Texas Gulf Sulphur Co. (No. 2), 312 F. Supp. 77 (S.D.N.Y. 1970) (on remand).
295 3 L. Loss at 1765; 6 L. Loss at 3875; *see also* 2 A. Bromberg, *supra* note 174, at 209.
296 Kardon v. National Gypsum Co., *supra* note 177.
297 List v. Fashion Park Inc., *supra* note 268.
298 *Id.* at 463.

cover the bulk of insider trading cases, and in open market cases the relevance of reliance itself is doubtful. Therefore, reliance appears to have become a more diverse concept. In cases of direct dealing apart from the open market, reliance may be a substitute for privity.[299] It may be considered as part of causation and inferred from materiality:

> "Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of his decision....This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact."[300]

It may be considered together with and part of scienter and causation, *i.e.*, "unnecessary in the limited instance when no volitional act is required and the result of a forced sale is exactly that intended by the wrongdoers".[301] Reliance may be a combination of privity and causation, *i.e.*, it becomes a question of "whether the plaintiff's injury was foreseeable" and, accordingly, the plaintiff "relied, if at all, on the fact that [the defendants] made tender offers in the first place".[302] The inference that reliance *per se* is a necessary element to determine recovery has troubled the courts. This may be the case when similar litigation arises in Canada.

As most insider trading cases involve non-disclosure of material facts, it is difficult to justify reliance as an element of offensive behaviour. It would be inconsistent to require reliance on facts which are not disclosed and the presence or absence of reliance on facts which would be varied by additional disclosure should not contribute to the gravity of an offence based on accountability. Whether it is a face-to-face or open market situation, there is no place for reliance on undisclosed information.[303]

In cases where the insider's representations in face-to-face transactions are at issue, there may be room for consideration of reliance.[304] Where the plaintiff gives no weight or credence to the insider's representations, knowing them to be false or incomplete, it may be proper to assert that recovery should be denied. Similarly, the insider who corrects misrepresentations may have a credi-

299 *See e.g.* Joseph v. Farnsworth Radio & Television Corp., *supra* note 269.
300 Affiliated Ute Citizens of Utah v. United States, *supra* note 267.
301 Vine v. Beneficial Finance Co., 374 F.2d 627, 635 (2d Cir. 1967).
302 Mutual Shares Corp. v. Genesco Inc., 266 F. Supp. 130, 133 (S.D.N.Y. 1967), *aff'd in part*, 384 F.2d 540 (2d Cir. 1967).
303 *See* 2 A. Bromberg, *supra* note 174, at 209.
304 *Id.*

ble defence. But even in such cases of non-reliance, the claimant should not be required to assert or prove reliance. The insider's obligations are founded on his duty to make full disclosure and the claimant's reliance or absence of it should be considerations for the insider defending the action. And if the insider can show the claimant was properly informed, his defence should succeed.

In any case, reliance should be a secondary consideration. This remnant of deceit actions can confuse the policy behind controls on insider trading when its only probative value is to amplify the nature of the insider's breach of duty and accountability. The relevance of reliance should only continue for purposes of proving such issues as materiality and, as the case may permit, causation, scienter and privity.

9. *Exceptions*

Notwithstanding the insider's use of specific confidential information, the Canada Act makes an exception for cases where "the information was known or ought reasonably to have been known" by the prospective claimant. The CBCA excepts cases where "the information was known or in the exercise of reasonable diligence could have been known". Ontario Bill 30 would permit a defence where there is "reasonable grounds to believe that such material change had been generally disclosed" or when "such material change was known or ought reasonably to have been known". The knowledge of the prospective plaintiff and the market may be critical, either as an adjunct of the insider's duty to disclose or as a corollary of whether the information was specific and confidential when used.

This exception should be workable in face-to-face transactions but may cause some interpretive questions for public market examples. In direct dealings, the court can reconstruct the plaintiff's knowledge at the time of a transaction and can respond to issues of causation, materiality and reliance before it considers the defence. But in the public market examples, the court has a more difficult task. It must determine the insider's duty to disclose particular facts, the impact in the market generally of the insider's behaviour and the obligations of particular market actors to be or become informed. The one opportunity for the court to have considered these questions, *Green v. Charterhouse*,[305] left an unsatisfactory conclusion in that, when it was determined that the quality of the information was not specific and confidential, the plaintiff's knowledge became somewhat academic. How the ques-

305 Green v. Charterhouse Group Canada Ltd., *supra* note 111.

tions of duty to disclose and obligation to learn will be answered is most material.

There is precedent for the insider's positive duty to disclose. At common law[306] and in *Green v. Charterhouse*,[307] there is reference to a duty to disclose in face-to-face transactions, the public market examples being less clear. In the United States, the court stated in *Kardon v. National Gypsum Co.*:

> "[T]hese provisions apply to directors and officers who, in purchasing the stock of the corporation from others, fail to disclose a fact coming to their knowledge by reason of their position, which would materially affect the judgment of the other party...."[308]

And in *Speed v. Transamerica*:

> "The duty to disclose stems from the necessity of preventing a corporate insider from utilizing his position to the unfair advantage....One of the primary purposes of [the 1934 Act] was to outlaw the use of insider information for ...financial advantage to the detriment of uninformed public securityholders."[309]

While it has been said that:

> "Requiring an insider to reveal every detail of the practice of the corporation with reference to its accounting methods and reserves and with reference to its assets and liabilities in general to a person as familiar with the company and its practices as the plaintiff would place an intolerable burden on insiders."[310]

The conclusion appears to be as follows:

> "An insider is not always foreclosed from investing in his own company merely because he may be more familiar with company operations than are outside investors. An insider's duty to disclose information or his duty to abstain from dealing in his company's securities arises only in those situations which are essentially extraordinary in nature and which are reasonably certain to have a substantial effect on the market price of the security if [the extraordinary situation were] disclosed."[311]

Canadian courts have the source material to quantify the insider's duty to disclose before they consider the plaintiff's knowledge.

If the insider proposes to make disclosure, what activity will

306 Gadsden v. Bennetto, *supra* note 110; Strong v. Repide, *supra* note 115.
307 Green v. Charterhouse Group Canada Ltd., *supra* note 111, 12 O.R. (2d) at 309 (C.A.).
308 Kardon v. National Gypsum Co., *supra* note 177.
309 99 F. Supp. 808, 829 (D. Del. 1951).
310 *See* 6 L. Loss at 3586, *quoting* Kohler v. Kohler Co., *supra* note 244, at 821.
311 SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968).

be sufficient? In direct dealing cases, the insider can determine the fullness of disclosure to the person with whom he deals and may elect not to disclose generally. In public market cases, the court in *Green v. Charterhouse*[312] was urged to adopt the standards in *TGS* where the court stated:

> "The release of a news release...is merely the first step in the process of dissemination required for compliance with the regulatory objective of providing all investors with an equal opportunity to make informed investment judgments. Assuming that the contents of the official [corporate] release could instantaneously be acted upon, at the minimum [the insider] should have waited until the news could reasonably have been expected to appear over the media of widest circulation, the Dow Jones broad tape, rather than hastening to insure an advantage to himself and his broker son-in-law."[313]

And further by way of *dictum*:

> "[W]here the news is a sort which is not readily translatable into investment action, insiders may not take advantage of their advance opportunity to evaluate the information by acting immediately upon dissemination."[314]

No Canadian court has been required to establish the standard of disclosure which would absolve insiders, but again, the results can be anticipated.

The plaintiff's obligation to inform himself is less clear. The CBCA, by referring to what the plaintiff could have known with reasonable diligence may have set a higher standard for the plaintiff than the Canada Act's reference to what ought to have been known. Ontario Bill 30 maintains the basic test of the plaintiff's knowledge of the Canada Act but permits the insider "reasonable grounds" for belief of general disclosure. Regardless of the language, the plaintiff appears to have a duty to be informed but whether he must take extensive steps toward diligent inquiry remains to be seen.[315]

As a general rule in Rule 10b-5 actions, a plaintiff's actual knowledge of undisclosed information will bar recovery. It is an unusual non-disclosure case which will permit recovery if the plaintiff is well informed.[316] The same general rules apply in

312 Green v. Charterhouse Group Canada Ltd., *supra* note 111, 12 O.R. (2d) at 309 (C.A.), [1973] 2 O.R. at 731 (H.C.).

313 SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 854 (2d Cir. 1968).

314 *Id.*

315 *See, Anisman* at 253; Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90, 106, (10th Cir. 1971).

316 *See e.g.* Texas Continental Life Ins. Co. v. Dunne, 307 F.2d 242, 247 (6th Cir. 1962).

misrepresentation cases where the plaintiff who is not misled will not likely recover.[317] But, for example, in derivative actions where the insider controls the plaintiff's behaviour, the corporation's actual knowledge is not critical.[318] The Canadian provisions should follow the U.S. example in cases of actual knowledge.

U.S. courts have been divided, however, in cases where the plaintiff has constructive knowledge of confidential information. It is these cases, where the exercise of due diligence by the plaintiff may have caused different results, that may be highly relevant for Canadian purposes. In the circuits where the courts have imposed a low scienter standard for the insider, a high standard of plaintiff's diligence has been required.[319] But in those circuits where scienter of the insider has been more critical, the plaintiffs have been permitted a lower standard of diligence in their inquiries.[320] And the impact of *Ernst & Ernst v. Hochfelder* may apply to vary.[321] This dichotomy on the question of constructive knowledge may trace the differences in wording between the Canada Act and the CBCA but, in any case, there is no conclusive rule which could be presented for Canadian purposes.

The equity barring recovery for plaintiffs who have not been affected by non-disclosure or misrepresentation can be lost if the rules to give effect to that give rise to a lower duty of the insider to disclose or a burdensome duty of diligence in the market. There can be little adverse effect on the insider's duty if the insider's defence is limited to cases of actual knowledge of the plaintiff. But the risk is that the market would be urged not to consider the insider's disclosures in open market cases. For cases where the insider deals directly with the complainant, the plaintiff's actual knowledge is an appropriate measure for this defence. In these cases, where reliance is material, the insider has the option and is encouraged to make detailed disclosure and to record this in agreements if he is unsure. In open market cases, actual knowledge and constructive knowledge of broadly disclosed public information should support an insider's defence. In this way, the insider is induced to either disclose or not trade and the standard imposed on market actors is to keep abreast of the information available in the market.

The remaining issue as to how much disclosure should be sufficient in open market cases is easily resolved. In addition to

317 *See e.g.* Gilbert v. Nixon, 429 F.2d 348, 355 (10th Cir. 1970).
318 *See e.g.* Schoenbaum v. Firstbrook, 405 F.2d 215 (2d Cir. 1968).
319 *See generally* 2 A. Bromberg, *supra* note 174, at 204, 248.
320 *Id.*
321 Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

examples of timely disclosure as are offered for issuers,[322] an insider should disclose to the regulatory agency, stock exchanges and to the press in accordance with precedents.[323] A reasonable time for dissemination should be required. However, rules must be flexible since interlisted securities traded across Canada will raise clearly different questions than a locally traded over-the-counter issue. The theory must be to equalize bargaining to the extent reasonably possible.

10. *Measure of Damages*

The Canada Act and the CBCA provide that the insider should compensate for "any direct loss suffered" and is accountable to the corporation "for any direct benefit or advantage received or receivable". Ontario Bill 30 would provide compensation "for damages as a result of the trade" and the insider would be accountable "for any benefit or advantage"; however, a formula for the measure of damages is provided.[324] The issues raised by these provisions extend beyond customary valuation questions in the absence of judicial interpretation.

It is difficult to quantify "direct loss".[325] There is no guidance as to whether the loss is to be determined following an assumption that the investor would have obtained the best price for the security in the intervening period, or on the basis that an improvident transaction with an insider was at a better price than could have been expected absent the insider's activities. All that can be readily determined when an insider buys is that the vendor decided to sell at the same time and that a different decision may have been made by the investor were he to have had the insider's knowledge. What cannot be determined is what the investor would have actually done. If the insider sold to an investor, it is clear that the buyer had an interest in purchasing but, again, it is debatable what the buyer would have actually done with different information. Would the investor elect against the transaction or merely postpone his activities and, if he postponed, for how long? There is room for significant speculation as to the measure of "direct loss".[326]

An accounting of the insider's benefit may be more straight-

322 *See e.g.* Toronto Stock Exchange, Members Manual G1-1 (1971); *see also* Uniform Act Policy No. 2-12, *supra* note 83; Ontario Securities Commission Policy 3-23, *supra* note 83.

323 *See generally* 3 A. Bromberg, *supra* note 174 ¶ 12.10.

324 Ontario Bill 30, s. 133(5).

325 *See, Anisman* at 243.

326 *See e.g. dictum* of the Court of Appeal in Green v. Charterhouse Group Canada Ltd., *supra* note 111, 12 O.R. 2d, at 313.

forward but it is hardly free from doubt. If the insider bought with the benefit of confidential information but has not yet sold, how will benefit be calculated? As the insider is still holding the securities, he must expect further appreciation in value but, when allegations are made, is the insider deemed to have sold, to have achieved optimum benefit during the period, or to be the subject of another standard? The supposition that the insider's benefit has run its course is as difficult when the insider sells to avoid a loss. The insider can be seen as having a benefit at any one of a number of subsequent prices. The measure of benefit is also susceptible to a number of interpretations.[327]

Ontario Bill 30 refers to "damages" and, to assist in the measure of them, subsection 133(5) provides that the price be compared to the sixty-day period following the transaction. This is a most constructive development in that a precise measure which the insider can take into account before he trades is provided. In addition, the test is somewhat more responsive to questions of causation than a measure formulated from "direct loss...as a result of the transaction". However, this measure is somewhat arbitrary in that "damages" are not always referable to a sixty-day price formula[328] and there is no account for the fact that litigation by many traders could have a draconian impact on the insider – indeed, far in excess of the insider's profit.

The wording of these provisions can be given weight in face-to-face transactions. In cases where there is privity, the expression "direct loss" lends itself to the interpretation that either a rescission or restitution theory of recovery is contemplated. Similarly, while "damages as a result of the trade" can be taken to include a theory of expectation interest limited by foreseeability, the formula to measure damages places the plaintiff in virtually the same position. "Direct benefit" or "any benefit" can be quantified. To the extent that there is a public market for the securities in question, evidence of securities prices and fluctuations during

327 Interestingly enough, Ontario Bill 30, s. 133(5), does not apply to s. 133(3), the provision of accountability to the corporation. In any case, *quaere* whether an insider receives any credit for damages paid to purchasers or sellers when the accounting is made for derivative recovery.

328 Although this is partially a question of semantics, the word "damages" is inappropriate. Ontario Bill 30, s. 133(5), sets a precise penal and compensation measure whereas use of the word damages presupposes that a court would consider classical contract or tort theories before reaching a conclusion. For example, consider the case of insider trades motivated by what is disclosed on the 1st to 30th days and a second price rise occurring on the 45th to 60th days referrable to new information which the insider did not use; the insider's liability is increased notwithstanding that he did not "make use" of the new information and the "damages" of the purchaser for insider trading are not referrable to such information.

specific time periods would be persuasive.[329] While there is risk of some imprecision,[330] the purpose and intent of the provisions should give rise to credible conclusions in private transactions.

The principal difficulties with the measure of damages as contemplated are in open market transactions. Here, in addition to the question of causation for purposes of measuring the "direct loss" and the possibility that matching of transactions may be required, there is the problem of timing. Is "direct loss" the same as "damages" having regard to the sixty-day average price or fluctuation in price that will be considered during, up to or some time after the transaction with the insider and the disclosure of the price-sensitive information?[331] In any case, if matching is not required, there is the possibility of unlimited liability of the insider as the direct losses and damages of many traders absent privity may be well in excess of the insider's profit and his financial worth. The conflicts within the provisions are further magnified by the fact that the benefit of the insider is simultaneously recoverable by the corporation. As the courts seek out an equitable solution, it may well demonstrate that these provisions are unworkable in open market cases with many plaintiffs.

In the United States with the experience of Rule 10b-5 cases similar problems are apparent. It may still be said that:

> "Few 10b-5 cases have reached the relief stage, so there is [relatively speaking] little law to report. Since far more decisions have gone for plaintiffs on the existence of a cause of action, the settlement proportion has been high but the terms have gone unpublished."[332]

The rules for measuring damages are developing and there are attendant theoretical difficulties.

In cases where there are few plaintiffs, the following rules have developed. Buyers from insiders have recovered damages on the basis that they receive back their purchase price.[333] This equivalent of court ordered rescission is without account for expectations or speculative profit. Sellers have recovered on the basis of an accounting of the insider's profit on resale, whether or not it is contemporaneous, and more recently on the basis of the difference between the amounts received and what the court determines to have been the actual value on the date of sale had the price-

329 *See, Anisman* at 245 for attempt at resolution.

330 *Id.*

331 *Quaere* whether a court interpreting the Canada Act or CBCA provisions will be persuaded by the Ontario Bill 30 formula if the latter is enacted.

332 3 A. BROMBERG, *supra* note 174, at 225.

333 *See e.g.* Stevens v. Vowell, 343 F.2d 374 (10th Cir. 1965); Royal Air Properties Inc. v.

sensitive information been properly disclosed.[334] Where there are no special considerations of many pending actions, the courts can and have treated damages as they would in simple tort or contract cases and the existence of and behaviour of securities in the public market constitute additional empirical data.

Where there are many actual or potential plaintiffs, there are obviously different considerations. The leading example of what can be done is *TGS* where the court[335] ordered the insiders to pay into a fund the difference between their purchase prices of shares and the mean average price of those shares on the date of full disclosure of the price-sensitive information to the public. The amount was to be held in escrow pending claims against it by the SEC, interested persons (such as sellers during the period) and the court. The court proposed to decide on individual recoveries and the balance of the fund would accrue to the company. This accounting might not be sufficient for all of the claims and expenses that could be satisfied in the case. However, this novel approach of the court underscores the different considerations where a large impersonal market is involved.

The U.S. example is useful for Canadian purposes but does not offer a complete solution. Canadian courts, to the extent it is necessary, will probably be persuaded by the U.S. authorities in cases where there is privity or where few claimants are involved. For the broader market cases, the results are unpredictable. In the former case, the court would be measuring damages on a basis consistent with the wording of the section and the causation test that are implicit. For the latter example, the court will not likely compensate for all "direct loss" or "damages" if that would cause too gross an impact on the insider and the court may, by relying on causation, privity or reliance, settle different rules. The *TGS* example does not follow from Canadian legislation and therefore the U.S. experience is helpful but hardly conclusive.

The concept of double liability whereby the insider may also be required to account to the company further complicates the area. This provision, which is somewhat unique to Canada,[336] is less than clear. For example, if plaintiffs have recovered direct losses

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Smith, 343 F.2d 374 (9th Cir. 1962); Royal Air Properties Inc. v. Smith (No. 2), 333 F.2d 568 (9th Cir. 1964).

334 *See e.g.* Janigan v. Taylor, 344 F.2d 781 (1st Cir. 1965); *see also* Affiliated Ute Citizens of Utah v. United States, *supra* note 267; Rochez Bros. Inc. v. Rhoades, 491 F.2d 402 (3d Cir. 1974); *see also, Anisman* at 243 for additional examples including comparable Canadian authorities.

335 446 F.2d 1301 (2d Cir. 1971); *see also* SEC v. Shapiro, 494 F.2d 1301 (2d Cir. 1974).

336 *See e.g.* 3 L. Loss at 1473; 6 L. Loss at 3646; SEC v. Texas Gulf Sulphur Co., *supra* note 335.

or damages, the insider may have no profits left or receivable as a result of the transactions which the company could recover.[337] And there may be an anomaly based on which insider liability action came first. Equally important, if the insider is liable to the company and personal plaintiffs follow, the court will be tempted to avoid undue harshness on the insider. It is apparent that double liability is intended but the practical applications cannot be accurately anticipated.

The measure of damages is an area where compromise should be sought. The small current risk of unlimited liability of the insider would be heightened significantly if causation concepts are removed from the legislation. At the same time, there are persuasive arguments that the insider should account for his benefits and compensate affected parties. The compromise that should appear in the legislation must make priorities within these considerations. While the insider commits an offence in the market when he abuses his position, the foundation for his liability is the abuse of position; the offence is the abuse and compensation is the punishment. Liability for this offence should be limited to a strict accounting of the insider's profit since insider liability should not be conceived as a broad insurance scheme for the market. Similarly, liability in excess of the insider's profit is a harsh sanction since a return of profits attended with adverse publicity and tax consequences should be sufficient. Individuals who seek compensation and the company should divide the insider's profit and, while it would be unusual for there to be adequate compensation for all, there would be at least a gesture of restitution in public market cases and almost full rescission in private transactions. This suggested solution would indicate that a plaintiff's cost at not proving causation and other elements of the offence would be that full tort or contract recovery may not be available.

How would profit be measured? If the insider resells or repurchases, he quantifies liability for primary consideration purposes. However, this would not account for the possibility that the insider has been a less than capable judge of the market or for the likelihood that an insider may taint the company's securities by virtue of his activities.[338] The court should be given the flexibility to determine the actual value of the securities at the time of the transaction and the insider's profit should be the court's determi-

337 *See e.g.* J. Williamson, Supp. at 362; F. Iacobucci, M. Pilkington & J. Pritchard, *supra* note 6, at 359; D. Johnston at 309.

338 While it may be argued that, ultimately, an action against insiders may promote the integrity of those same insiders, the immediate impact of insider activity should be suspicion of the company's securities generally.

nation of the difference between actual value and the insider's price.[339] With the conceded benefit of hindsight, the court can find the impact of the price-sensitive information and it will have the appropriate records of trading. The risk that such use of hindsight may impute advantage to the insider in excess of his actual profit should appropriately be the insider's. In effect, the insider's profit should be an exercise in effecting rescission.

11. *Limitation Period*

The Canada Act and the CBCA provide that an action to enforce insider liabilities may be commenced only within two years from the date of the completion of the transaction giving rise to the cause of action or, if the transaction should have been reported in insider reports, within two years from the time of reporting in compliance with the reporting obligations.[340] Ontario Bill 30, in section 137, has provided a fixed three years from the date of the transaction that gave rise to the liability. There is no guidance as to the interpretation of a number of considerations raised by these limitations.

Assuming that the insider is involved in a number of transactions, from what date is the two- or three-year limitation period calculated? In order for an insider to accumulate a significant number of securities, "the" transaction could, as a practical matter, be a number of transactions taking place over a number of weeks or months. In cases involving multiple transactions, "the" transaction may not be the clearest indication.[341] Similarly, "the" transaction which gives rise to "direct loss" would be different for various plaintiffs and there are procedural considerations which would have to be taken into account.[342] The description of the limitation periods in the statutory provisions could have been more clearly stated.

The more important consideration raised by the limitation period is the treatment of the transactions which should have been reported. The section contemplates that if the transaction is required to be reported, it would have been reported in compliance with the legislative provision. However, if the transaction is not

339 *See e.g.* ALI Federal Securities Code, Tent. Draft No. 2, s. 1402(f)(2)(B) (1973).

340 Canada Act, s. 100.4(2); CBCA, s. 125(6); *see, Anisman* at 265; D. Johnston at 309.

341 As a matter of statutory interpretation, the singular would include the plural; *quaere*, how a sale by a plaintiff two years and six months preceding the date of action will be treated if the last of the insider's trading took place 18 months before the action is bought by the plaintiff.

342 For example, can the hypothetical plaintiff referred to *id.* be sheltered by a later action? It is submitted that the limitation period does not properly address the open market cases.

reported, does this mean that no limitation period applies? On the other hand, if the transaction is reported late, which would not be in compliance with the legislation, or not reported at all, does the limitation period run from the time that the report should have been filed or, in the case of a late report, from the date of the filing of the late report? In such cases, an insider who is concerned about his liability may be advised not to file his insider reports and run the risk of prosecution for failure to file since several available interpretations might operate to his favour. The limitation period is suspect and therefore undesirable.

The earlier version of Ontario Bill 30 highlighted the peculiar problem with limitation periods for insider trading. In Ontario Bill 75,[343] an action had to be commenced "only within one year after the date knowledge of the facts that gave rise to the action first came to the attention of the plaintiff or reasonably ought to have come to his attention". As essential features to insider trading involve use of secret information and masking identity of the trader, it is usually difficult to determine when an insider has traded and, therefore, when a cause of action has accrued. This becomes especially difficult when the category of persons who may be liable as insiders is broadened to include people who need not report their transactions. The policy of including a limitation period is justifiable but the risk of making the limitation period "reasonable" or permitting it to commence from the time the insider traded is that it would be difficult if not impossible to determine that a cause of action existed within the time prescribed. For this reason, the limitation period must be framed with reference to availability of information for purposes of an insider liabilities action.

The limitation period set forth in insider trading provisions should be varied with a view to clarity and in a manner which is sympathetic to how insider trading takes place. In cases where the insider is subject to the reporting requirements, a limitation period of two years should apply from the later of the last transaction constituting improper insider trading or first disclosure of the price-sensitive information. The aggrieved party would within that time know that the insider traded at a time that confidential information was not disclosed. For cases where the insider need not report his transactions, a limitation period of three years should apply from the date of first public disclosure of confidential information. The addition of one year to the limitation period is purely arbitrary with the only justification for the additional time

343 Bill 75, The Securities Act, 1974, Ontario, 29th Legis., 4th Sess. (First Reading, June 7, 1974).

being that in such cases it would take a prospective plaintiff somewhat longer to determine that improper insider trading has taken place. The remaining possibility, that of an insider who should have reported but did not, should be treated as a case where the insider did not need to report in that a three-year limitation period from the date the confidential information was first made public should apply. The solution for this last case is again arbitrary so that some limitation period will apply and, for the insider who chooses to run the risk of not reporting, he will be subject to a longer limitation period and the risk of prosecution for failure to file reports. Finally, the court should be left with some flexibility in that, if the insider makes efforts to deliberately conceal his transactions, an appropriate remedy should be extended.

12. *Additional Considerations in Bringing an Action*

The dearth of reported cases pursuant to the insider liability provisions indicates that there are a number of considerations against bringing insider liability actions. Since insider liabilities are closely tied to private enforcement, these considerations are of paramount importance.

In the preceding sections, the legal questions of proof facing a plaintiff were discussed. It is apparent that unless the plaintiff was victimized in a face-to-face transaction, there are significant questions arising from the lack of clarity in the wording of the sections and, more important, the plaintiff's burden of proof in respect of causation and the possible inference that proof of privity, scienter and reliance will be required. While the purpose and intent of the liability provisions are determinable, a plaintiff would be concerned as to the nature and amount of his damages and, most important, whether he must match his transactions in order to prove damages at all. A plaintiff in Canada at present has little guidance on what he must prove to succeed and what he will recover if he does.

A more immediate consideration for a prospective plaintiff is the considerable cost of maintaining an action. Since contingency fees are not permitted in most Canadian jurisdictions, a plaintiff bears the cost of all preliminary investigations and of pursuing his action. If he finds that he does not have a cause of action after investigation, he forfeits those costs. If the plaintiff proposes to maintain a "borderline" action, he risks being liable for the costs of the insider defending such a lawsuit if it proves to be unsuccessful. These initial costs for a dubious return underline why very few plaintiffs will have a significant enough investment to even consider bringing an action. The prospective plaintiff should have a

substantial interest in the securities of the company before it is economically worthwhile to bring an action and it may be argued that the only potential plaintiffs with such a significant enough stake are shareholders who have enough influence to obtain confidential information on their own or financial institutions which may be receiving favoured treatment in any event. It may be seen that, while the liabilities may be technically very broad, the initial costs dramatically discourage enforcement to the point that an insider's risk of a lawsuit is minimal and the legislation may very well be unenforceable. The adage that a shareholder who does not agree with management policies sells his securities rather than fight management has a special relevance in the insider trading area.

These concerns of private enforcement must remain to some extent. Proposals for legislative change can give effect to clarifying the liabilities provisions, reducing legal barriers to successful action and promoting access to information. The section of this paper which follows should also be some consolation in that the legislative provisions will not rely exclusively on private enforcement for remedial impact. However, whether contingency fees or other inducements should be given to plaintiffs in insider trading actions is quite a separate question. In view of the mixed experience in the United States,[344] such inducements are not suggested herein. However, with experience in the new legislation, this issue should be reconsidered.

13. *Role of the Regulatory Agency*

Section 100.5 of the Canada Act provides that a person who was a shareholder at the time the insider's transaction took place or the Minister of Consumer and Corporate Affairs may apply to the court for an order and, if the court is satisfied, that the company has a cause of action for recovery of the insider's profits or that the company has failed to prosecute its claim diligently, the court may order the Director of the Corporations Branch to commence or continue an action for and on behalf of the company. This provision differs slightly from those contained in provincial securities statutes[345] which provide for the same remedial action but not for ministerial application. The CBCA provides that the Director is a "complainant"[346] with the result that he is entitled to invoke the remedies provided in the CBCA. Similar provisions are sug-

344 *See e.g.* KIMBER REPORT, ¶ 2.28; 2 L. LOSS at 1053.
345 *See e.g.* Ontario Act, s. 114.
346 CBCA, ss. 125(5)(b), 231, 232.

gested in Ontario Bill 30, albeit with some clarification as to at whose expense the action will be brought and with the addition of the OSC as a complainant.[347] This regulatory agency-assisted derivative action is an interesting supplement to private enforcement.

Experience has shown this to be a less than exciting dimension to the regulation. Apart from the suspicions that were raised by commentators respecting the provincial provisions[348] and the concerns where the Minister and Director have been inactive, the one order made pursuant to section 114 of the Ontario Act in the *Multiple Access* case[349] was disappointing. The court's determination that the applicants would be required to pay costs of the company and of the OSC if the action on the merits was unsuccessful has the effect of making these agency-assisted derivative suits highly unlikely at the provincial level and perhaps generally. The exceptions for cases where there is absolute certainty or where the applicant's proportionate share in derivative recovery is an inducement remain. The theory of the agency's assistance to private plaintiffs is lost if the assisted party bears the risk of costs.

The attempt at clarification in Ontario Bill 30 and the addition of the OSC as a potential complainant may be constructive. The new provisions require a securityholder at the time of the transaction in question or the OSC to apply to the High Court which, if satisfied that there are reasonable grounds for action and the reporting issuer has either failed to commence an action after notice or to diligently prosecute one that was commenced, may order the OSC to proceed on behalf of the issuer. If the court is satisfied that the action is *prima facie* in the best interests of the company, the court may order that the company pay the costs. It is debatable whether the OSC's posture in the prosecution of insider trading cases will be materially changed. The OSC has had other remedies where there has been insider trading, such as conducting an investigation and hearing for the purpose of denying the exemption to trade, which have been used sparingly in the past.[350] Authority for the court to require the issuer to pay costs is in the statute currently (since the issuer was nominally the plaintiff) and the new provision may cause the issuer to pay costs even if it wins the action. In effect, there is no change and Ontario Bill 30 is merely directory as to interpretation.

The justifications for participation of the regulatory agency

347 Ontario Bill 30, s. 134.

348 *See*, J. Williamson, Supp. at 364; W. Painter, *supra* note 51, at 372; *see also* D. Johnston at 308.

349 *In re* Multiple Access Ltd., *supra* note 137.

350 Indeed, Connor, *supra* note 139, is the only significant example.

in civil enforcement are readily apparent. The private plaintiff's considerations of cost compared to his proportionate share of recovery, his risks both from uncertainty in the law generally and of meeting particular burdens of proof and the complexities of such lawsuits where information may be scarce are all much less relevant considerations for a regulatory agency. With comparatively greater access to information and, in any case, stronger investigative powers, a regulatory agency is the most credible complainant in such cases.[351] As a result, it can be said that the courts may yet give effect to the potential remedial impact of such provisions, and Ontario Bill 30, by clarifying the issue of costs and the specific addition of the regulatory agency as a complainant, may represent the appropriate response for immediate purposes.

It should be noted, however, that such a role for the regulatory agency is subject to significant limitations. Assistance of the agency on this derivative basis is only slightly responsive to the compensatory considerations with insider trading since recovery by the corporation does not mean the shareholder will receive any immediate benefit, either by way of distribution from the issuer or in the share price, and the remedy merely underlines the insider's accountability for profits. Sellers to insiders receive no benefit. While recovery by the corporation may offer subsequent evidence for private actions, questions of measure of damages and the limitation period may arise.[352] The disgorging of profits by the insider satisfies, to some extent, the penal considerations of insider trading but, if the agency's sole remedy is to seek repayment of the profits, that is a limited penal sanction in the final analysis. The involvement of the regulatory agency in this way should be seen as a first step to the agency's participation in the area.

Ontario Bill 30 contemplates a measure of criminal liability for insider trading.[353] Such provisions depart somewhat from the previous emphasis in the legislation whereby private compensation was the principal remedial feature of the regulation of insider trading. There is less reliance on the fact that insider trading must cause a sufficient loss before the remedial provisions are invoked and on the supposition that cases where private compensation will be sought will mirror instances of insider abuse meriting public concern. Imposition of criminal liability irrespective of compensation confirms that there are cases which should be prosecuted in the public interest, whether or not there is economic harm, and on the basis that general abuse should be curbed regardless of specific

351 In fact, if the insiders have secured shareholder ratification of their activities or the company has not suffered damage, it may be the only remedy; *see, Anisman* at 264.

352 *See* text at ch. III, sections c. 10, c. 11, *supra*.

353 *See* Ontario Bill 30, s. 77; *see also* British Columbia Securities Act, s. 111.

impacts. Furthermore, if the offence is characterized as more than a statutory tort, there is a more realistic basis for other relief, such as injunction, that could be sought by the regulatory agency. Criminal liability, with a corresponding prosecutorial role for the regulatory agency, is consistent with the public nature of the abuse of insider trading and follows the experience in other jurisdictions.

The role of the regulatory agency with insider trading liabilities should, therefore, be extensive. In the first instance, the agency should be permitted strong involvement on behalf of the company since, for many cases, this will involve a reasonable penal sanction, and some assistance for compensatory considerations and evidence for purposes of contemporaneous or subsequent private actions. Criminal prosecutions or injunctive relief should be available for gross cases of abuse or where economic loss is not readily apparent as this will furnish the sanction of adverse publicity and a further evidentiary base for subsequent civil actions. The final area where the regulatory agency should be involved is the provision in legislation for class actions by the agency. In addition to bringing action on behalf of the company, the agency should be permitted to bring action on behalf of all traders during the period the insider trading took place.[354] This final remedy satisfies penal and accountability considerations, *i.e.*, the economic sanction of disgorged profits and the compensatory considerations of proportionate recovery. These powers of the agency are complementary and the public sponsorship of such remedies is warranted by the experience.[355]

D. RELATED AREAS FOR CONSIDERATION

1. *Continuous Disclosure*

Implicit in the regulation of insider trading is that there be means and procedures for disclosure of material confidential information. It is not suggested that insiders be prohibited from trading but only that, when they trade, they do so within prescribed rules. Under the Canada Act and the CBCA, there are no express avenues provided for adequate public disclosure to the market and, as the statutes are corporations law, this may be justifiable. Under provincial securities law, there is provision pur-

354 For an example of the difficulties encountered with private class actions; *see* Farnham v. Fingold, *supra* note 136.

355 *E.g.* consider TGS in the absence of such remedies.

suant to policy statements for timely disclosure.[356] However, in statutes where the focus is disclosure on the distributions of securities and the regulation of industry personnel, such regulation by policy statement is less than desirable. For companies whose securities are listed on stock exchanges, the listing agreement and resulting rules that apply require timely disclosure and a procedure is provided;[357] this is not a substitute that is equitable for the insider seeking to comply with legal standards. At present, there is an incomplete system for the timely disclosure of material confidential information.

In the *Grover & Baillie* paper in this volume, disclosure is considered in greater detail. Similarly, initiatives as outlined in Ontario Bill 30 are constructive for purposes of establishing a more complete system for disclosure. However, it is expected that any expansion of duties and liabilities of insiders would be complemented by broader continuing disclosure obligations. Questions as to what is or might be disclosed by the issuer should not be overlooked.

2. *Takeover Bids*

Although there is detailed regulation of takeover bids in the Canada Act, the CBCA and provincial securities legislation,[358] the event of a takeover bid raises additional insider trading questions. In both the Canada Act and the CBCA, there are provisions responsive to some of the peculiarities in that, in both statutes, a person becoming an insider is deemed to have been an insider for the preceding six months and, in the CBCA, the definition of insider would embrace several of the interested parties in a takeover bid.[359] But, if the insider trading sections are meant to regulate transactions in circumstances of a takeover bid, the regulation is incomplete. The insider trading provisions have limited impact on "warehousing"[360] or, for that matter, on the takeover bidder if the information is not received from the corporation.[361] It must be decided whether insider trading liabilities are meant as a primary regulatory tool in the control of

356 *See* note 328 *supra*.

357 *Id.*

358 Comprehensive treatment of this subject is presented in P. ANISMAN.

359 *See, Anisman* at 267.

360 JUSTICE, *supra* note 105, at 10, defines warehousing as "a situation in which a number of parties act in undisclosed concert... each acquiring an interest in the equity of the company... thus enabling one or more of them to acquire by stealth a dominant position in that company". Essentially, "warehousing" avoids insider reporting and, in current provincial statutes and the Canada Act, insider trading liability; *see also* P. ANISMAN at 115-44.

361 *See* P. ANISMAN at 267 for a good discussion of CBCA impact.

takeover bids or whether such liabilities will merely be complementary.

To the extent that takeover bids raise special considerations, it is submitted that such considerations are somewhat alien to insider trading and should be treated separately. Regulatory considerations applicable to takeover bids have been well documented[362] but most if not all of the special considerations involve information which is not corporate sourced, *i.e.*, the fact that a bid will be made and the acquisition of shares pursuant to the bid. Such information, while clearly material and confidential, should not give rise to insider liabilities which are, to a great extent, founded on accountability for position. There is no immediate fiduciary relationship between a takeover bidder and the target company nor between the takeover bidder and the target company's shareholders so that the regulation of takeover bids is more directly a matter of market regulation than the regulation of insider trading. For these reasons, the regulation of takeover bids should be a consideration in the framing of insider trading liabilities where corporate-sourced information is at issue but, in cases where the material confidential information emanates from other than a corporate source, regulation should not be founded on theories of insider trading.

3. *Corporate Repurchases*

Recent amendments to corporations law permitting companies to purchase their own common shares[363] have heralded several recent efforts by companies to buy such shares in the open market. A company's decision to buy such shares may be motivated by such altruistic motives as the decision of management that the company's own shares are a good long-term corporate investment or that shares in the open market are cheaper for purposes of satisfying obligations in stock option and stock purchase plans than would be treasury shares. Reasons that such activities are suspect include that corporate repurchases may operate to confer an inordinate benefit on controlling shareholders to the exclusion of those who sell, provide artificial short-term price support for shares in the market, change control relationships in the company which may be material, sympathize with maintenance of current management in control of the company or show the shares are grossly undervalued in view of information which has not been disclosed. While each of the statutes permitting

362 *See* P. ANISMAN, *passim*.
363 *See e.g.* CBCA, s. 32.

companies to buy back their common shares provides that the company is an insider of itself,[364] there remains the question of whether this is sufficient regulation.

The arguments which would support the recent provisions requiring additional disclosure in the regulations pursuant to the CBCA and in the policy statements under the Ontario Securities Act are persuasive.[365] As corporate repurchases are often "exempt offers" and are treated otherwise than as takeover bids,[366] it should be argued that additional disclosures to the market are required. However, whether such additional disclosure should be part of insider trading regulation is quite a separate issue. If the company repurchasing its shares fails to disclose its activities in advance, it assumes the same risks as would any other insider in the acquisition of shares. If a higher duty is required of corporations buying their shares, such a duty does not emanate from the accountability of insiders but rather as a dimension of general market regulation.

4. *Other Conflicts of Interest*

There are a number of other situations which are often colloquially referred to as "insider trading". The mutual fund manager who buys securities knowing that the mutual fund is contemplating a similar acquisition and the investment manager at a financial institution engaging in similar activities are two immediate examples. The more difficult case is the executive of a mining company who, knowing the pricing policies of his company, deals extensively in the commodity or the securities of a competitor thereby avoiding dealing in securities of the company. Many examples involving "market information" would fall into a similar category. All of the cases demonstrate dealing by someone who is considered an "insider" but, neither by definition in the statute or from the supporting theories for the regulation of insider trading are such activities regulated. It may be suggested that insider trading liabilities be extended to apply to such conflict-of-interest cases.[367]

While there may be merit in the extension of insider trading controls to cover conflicts of interest among corporate directors

364 *See e.g.* CBCA, s. 125(1)(b).

365 *See e.g.* CBCA, s. 187 "takeover bid".

366 For example, since shares purchased by a company become non-voting, a corporate repurchase would not be a "takeover bid" as defined by the Ontario Act, s. 81(g); *see* Ontario Securities Act, s. 81(b) for examples of expressly "exempt offers".

367 Indeed, a logical extension of the provisions of Ontario Bill 30 would regulate much of this type of behaviour; *see* discussion of "materiality" in ch. III, section c. 6 *supra*.

and officers generally, there would probably be too many attendant difficulties. At present, regulation of insider trading is conceived to provide codification of a standard of behaviour, information for purposes of enforcement and a relatively simple remedy. Whether the same should apply or could be reasonably extended to conflicts of interest generally is quite a different issue. With insider trading, the fiduciary duties of the insider meld with the fact that a public market for the issuer's securities imposes higher standards of care. Cases of conflict of interest not involving the immediate market for the company's securities should give rise to different considerations which, in any case, may not deviate from fiduciary responsibilities in the general corporations law. It would require significant additional analysis before one could impose liability of a mutual fund manager to the securities market or on a mining company executive to the commodities market and, for immediate purposes, it is submitted that such liability should not be imposed pursuant to regulation of insider trading.

Chapter IV
Role for Federal Regulation

A. INTRODUCTION

The proposition that additional federal regulation of insider trading would be desirable is debatable. Quite clearly, any new initiatives would be duplicative of existing and, in any event, proposed provincial laws. Similarly, there is the slight risk of conflict of any federal position with provincial standards. The fact that the Atlantic provinces do not regulate insider trading does not appear to be a significant enough justification for federal intervention in a vacant area in view of the smaller market and potential for abuse as well as the significant likelihood that questionable dealings would take place in a jurisdiction such as Ontario or Québec where the benefits of legislative controls would be extended. While each of these potential concerns can be satisfied, there is no startling benefit which would accrue from more federal regulation of insider trading in Canada and which could not be accomplished by amendments to existing federal regulation and by the provinces.

The arguments to support federal securities regulation generally apply equally to the area of insider trading. To highlight some of them, a stronger sanction from the federal criminal law power and wider based enforcement may be anticipated, many of the jurisdictional questions raised by interprovincial trading would be answered, a federal regulatory system could be less costly

over the longer term with a fully integrated and strongly sponsored regulatory system, etc. Incidence of abusive insider trading may underscore the weaknesses in a system of securities regulation.[368] But, insider trading itself does not appear to be a significant enough abuse to warrant address from national regulation. Indeed, regulation of the subject is complementary to general securities regulation and the aim of promoting fair dealing in the market.

The regulation of insider trading does emphasize some conceptual problems, inasmuch as there may be an inherent conflict of securities regulation and the corporations law.[369] The *Multiple Access* case,[370] in which provincial regulation of insider trading in the securities of federal companies was struck down, demonstrates the fine line between regulation of this behaviour in the corporations law and at the same time in the securities law when both the federal government and the provinces have authority to regulate the areas. The conceptual problems become more acute when it is remembered that primary regulation of the relationship between a company, its directors and officers and its shareholders is contained in the corporations law and regulation of the market in securities law may involve different considerations. For example, if shareholders ratify the non-disclosure and insider trading, which could be a corporations law method of absolving directors in a conflict case, should an insider remain accountable?[371] Resolution of these fundamental issues in justification of federal securities regulation generally will be responsive to any peculiar question raised by insider trading. But there will remain, nonetheless, the potential for conflicting theories and goals to militate against consistent and effective regulation.

It may be anticipated that additional regulation of insider trading will not be welcomed or popular and more laws to govern already extensively regulated behaviour may not be justifiable. There are limits on how far it is possible to regulate business morality and any such attempt may be futile. Arguments to indicate that the regulation of insider trading is inefficient from the economic point of view should not be ignored entirely.[372] Although most observers would concede the desirability of regulating insid-

368 *See e.g.* COMPANY LAW ADVISORY COMMITTEE, FOURTH INTERIM REPORT TO THE STANDING COMMITTEE OF ATTORNEYS-GENERAL ON MISUSE OF CONFIDENTIAL INFORMATION, DEALINGS IN OPTIONS, DISCLOSURE BY DIRECTORS (Australia 1970).

369 *See e.g.* W. PAINTER, *supra* note 51, ch. VIII.

370 *In re* Multiple Access Ltd., *supra* note 137.

371 *See e.g. Anisman* at 267; in the U.S. consider as examples O'Neill v. Maytag, 339 F.2d 764 (2d Cir. 1964); Ruckle v. Roto American Corp., 339 F.2d 24 (2d Cir. 1964).

372 *See e.g.*, W. PAINTER, *supra* note 51, ch. XI for a summary of arguments.

er trading, the commitment of additional resources to satisfy what may be viewed as technical shortcomings is questionable.

B. RECOMMENDATIONS AND CONCLUSIONS

While the arguments and observations which would indicate that additional federal regulation of insider trading would be undesirable are persuasive, there is justification for federal initiatives in the area. From a historical viewpoint, the regulation of insider trading has developed from individual fiduciary standards to legislative controls on the basis that the setting of a public market justifies broader regulation. It is a logical extension that as the market becomes and is national in scope, the legislative controls and capabilities of local regulation, albeit with extensive cooperation, become less credible. For example, the OSC's investigation of the insiders of a Nova Scotia based company[373] may be justified by the terms of the Ontario Securities Act. However, if the issuer, most of the insiders and the traders are located outside the enforcing province, such regulation can be viewed as an unwarranted intrusion into another province's jurisdiction as well as a questionable commitment of the first province's resources. Since any one province should be committed to regulation primarily within its boundaries, federal regulation is the more desirable method to approach problems where no single province may have the political or logical justification to do so.

Much of the reluctance that would attend new federal initiatives to regulate insider trading stems from a presumption that this would be additional regulation instead of substituted standards. The regulation of insider trading is an ideal subject for federal controls – virtually to the exclusion of provincial initiatives. While additional federal law in the area could be duplicative, may give rise to conflicts and only identify an unregulated problem in few provinces, the attraction of one federal standard which would replace the duplication and conflict which already exists with seven regulatory codes is strong. The inherent conflict of corporations and securities laws would be minimized with one regulatory code since it would not be the effort of one province regulating the internal workings of an entity created by another but a federal umbrella over all such entities carrying on business in Canada. There may be considerable acceptance and popularity of a single legislative standard which operates to replace significant amounts of similar laws and offers the possibility of economically efficient administration. The real justification for and role of

373 Re Harold P. Connor, *supra* note 139.

federal intervention in this area at present is the expectation that the most pragmatic solution has been chosen.

Recommendations to the effect that there should be federal regulation of insider trading and securities trading generally are neither novel nor do they hold the prospect of immediate implementation. It must be conceded that the provinces have made progress in curbing abuses and that their administrators constitute the most experienced personnel to enforce such laws. Insofar as federal regulation must rely on and work from the provincial experience, it is imperative that any implementation of the proposals herein be undertaken following consultation, both as to feasibility and transition, with provincial administrators. It may be that there is a continuing justification for provincial regulation, *i.e.*, with purely local issuers and in closely-held companies, and the division of authority should be clearly stated. It is hoped that further study and negotiation will lead to a more comprehensive and acceptable regulatory environment.

Canadian Financial Institutions

J. Peter Williamson

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Chapter I
Introduction

The transfer of savings from individuals and nonfinancial businesses to the users of capital that include governments, individuals and business is heavily dependent on financial institutions. Chapter I presents a brief and largely statistical picture of financial institutions in Canada.

Chapter II is concerned with the Canadian securities industry. Securities firms are unlike the institutions described in chapter I, which generally accept investment funds from a clientele and then reinvest the funds in stocks, bonds, mortgages and so forth. The securities firms act as agents in bringing buyers and sellers of investment securities together and as dealers, buying and selling securities for their own accounts. Chapter II describes the securities industry, its self-regulatory organizations, and the activities of its members. It goes on to describe competition in the industry, sources and adequacy of capital for securities firms, and foreign ownership of Canadian firms.

Chapter III deals with the commission rates of Canadian stockbrokers, and the economics of the brokerage business. The

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United States experience in unfixing commission rates is discussed first, and is followed by a review of the Canadian position.

Chapter IV considers the role of banks and trust companies in the securities markets, and compares the U.S. and Canadian situations. In both countries there is disagreement and uncertainty about locating a line of demarcation between activities reserved for the securities industry and those open to banks and trust companies.

Chapter V discusses the roles of institutions and independent individual investors in the stock market. The trend in recent years has been toward increased institutionalization and has led to concern over the quality of securities markets and possible concentration of economic power in institutions.

The principal types of Canadian financial institutions are listed in table 1. The chartered banks are the largest by far. Trust companies, including assets held in trust, are about half the size of the banks. Life insurance companies and trusteed pension plans are about tied in third place and credit unions are fourth. All the others are much smaller.

Table 2 shows the securities holdings of these institutions. Information is not complete, especially for the chartered banks which do not disclose their holdings of corporate stocks. Pension funds, life insurance companies and mutual funds account for almost all of the institutional holdings of stocks, apart from common stock holdings in trust accounts of trust companies (see table 3). Corporate bonds are held principally by life insurance companies, pension funds, banks, provincial and municipal governments, and other insurance companies.

A. CHARTERED BANKS

In Canada the term "bank" refers only to institutions chartered under the federal Bank Act. Table 1 shows banks to be the dominant financial institution in Canada. Table 4 lists the major chartered banks and it is clear that five banks dominate the group.

The Canadian banking system is unusual in its very high degree of concentration and in the large branch networks of the dominant banks. These large branch networks are significant for the purposes of this paper because they could form the vehicle for providing throughout the country a variety of financial services beyond traditional commercial banking. The five major banks operate more than 6,500 branches in all provinces of Canada. At the same time, the existence of this branch system poses a constant competitive threat to financial institutions other than banks. The brokerage and investment dealer industry, in particular, has

Table 1
Total Assets of Canadian Financial Institutions

As of December 31, 1974–76
In millions of dollars

	1974	1975	1976
Chartered banks	87,458	100,380	116,843
Québec savings banks	884	971	1,118
Trust companies (including guaranteed funds)	12,442	14,604	18,335
Assets in trust	28,384	32,332	
Mortgage loan companies	6,743	8,017	9,332
Local credit unions and caisses populaires	10,315	12,791	14,987
Central credit unions	1,920	2,602	2,937[a]
Sales finance and consumer loan companies	9,461	10,336	11,141
Leasing companies	643	806	1,055
Life insurance companies (assets in Canada)	20,540	23,834	
Other insurance companies	4,823	5,556	6,679
Investment dealers	3,459	3,673	4,700
Mortgage investment trust corporations	832	1,052	1,267
Mutual funds	2,368	2,769	2,874
Closed-end funds	801	921	694
Trusteed pension funds			
Industrial	9,223	10,583	25,234
Other	8,861	10,379	
Total	209,157	241,606	

a. Third quarter.
Sources: *Bank of Canada Review;* Statistics Canada, *Financial Institutions,* various issues.

Table 2
Securities Holdings of Canadian Financial Institutions

As of December 31, 1976
In millions of dollars

	Canadian government securities	Provincial and municipal securities
Chartered banks	8,526	1,135
Québec savings banks	32	170
Trust and mortgage loan companies	578	541
Central credit unions and caisses populaires[a]	150	982
Local credit unions and caisses populaires	33	563
Sales finance and consumer loan companies	12	5
Life insurance companies	612	1,825
Other insurance companies	772	1,432
Mutual funds	48	47
Closed-end funds	4	5
Trusteed pension funds		
Industrial	202	941
Other	203	5,246
Provincial and municipal governments	416	4,545
Investment dealers	564	275
Non-residents	1,074	15,155
Residual	1,593[b]	3,857
Total	14,819	36,724

Corporate bonds and debentures	Mortgage loans	Commercial paper	Preferred and common stocks	Foreign securities
2,675	8,681		?	510
52	603			
519	20,718	285	489	37
89	43	305	21	
76	6,649	2	26	
14	890	35	2	
5,447	9,117	5,041	1,950	443
1,409	197		892	128
141	632	64	1,169	486
20		3	371	22
2,348	1,346		3,298	484
1,191	1,124		1,302	242
1,549				
84		1,011	17	19
7,235				
3,060				
5,909	50,000	6,746	9,537	2,371

a. Third quarter.
b. Excludes $15,835 Canada Savings Bonds and $8,621 held by the Bank of Canada and Government Accounts.
Sources: *Bank of Canada Review;* Statistics Canada, *Financial Institutions,* various issues.

Table 3
Securities Holdings of Trust Company Trust Accounts

As of December 31, 1975
In millions of dollars

Bonds	Mortgage loans	Stocks
12,563	4,868	12,104

Source: *Report of the Ontario Registrar of Trust and Loan Companies for 1975.*

Table 4
Total Assets of Canadian Chartered Banks[a]: Outstanding Debentures and Shareholders' Equity

As of October 31, 1974–77
In millions of dollars

	Assets				Outstanding debentures 1976	Shareholders equity 1976
	1974	1975	1976	1977[b]		
The Royal Bank of Canada	21,669	25,211	28,831	35,671	270	731
Canadian Imperial Bank of Commerce	18,946	22,259	26,104	32,782	225	640
Bank of Montreal	17,651	18,243	20,492	25,908	240	541
The Bank of Nova Scotia	13,462	16,006	18,181	22,113	166	606
The Toronto-Dominion Bank	11,857	13,577	16,192	19,467	166	491
Bank Canadian National	4,126	4,872	5,675	6,837	60	132
The Provincial Bank of Canada	2,739	3,059	3,624	4,366	35	81
The Mercantile Bank of Canada	699	1,288	1,708	2,014		62
The Montreal City and District Savings Bank	873	969	1,124	1,232[c]		
Bank of British Columbia	503	625	844	1,144	8	23
Total	92,525	106,109	122,775		1,170	3,307

a. Includes Québec savings bank.
b. As of December 31.
c. As of October 31.
Sources: Annual reports of banks listed.

reason to be fearful of an expansion of the chartered banks into broker-related services.

Of the banks listed in table 4, the first five operate across the country. The Bank Canadian National and The Provincial Bank of Canada limit themselves essentially to the province of Québec. The Bank of British Columbia operates in British Columbia. The Mercantile Bank of Canada, at one time a subsidiary of First National City Bank of New York, specializes in corporate finance in major financial centres.

Foreign currency assets and liabilities of the banks have been growing much faster than Canadian dollar assets and liabilities over the past decade or so. In 1964 foreign currency assets amounted to 21.7% of total assets for the banks and by 1974 this ratio had risen to 29.5%. The Royal Bank of Canada has consistently had the largest foreign currency assets in recent years, with The Bank of Nova Scotia and the Bank of Montreal vying for second place. In recent years, particularly after the imposition of Canadian voluntary capital outflow guidelines in 1968, the percentage of foreign currency assets and liabilities booked outside Canada has increased substantially. In 1976, for the five largest banks, revenue from international activity as a percent of total revenue ranged from 21% (Canadian Imperial Bank of Commerce) to 35% (Bank of Nova Scotia).

The ownership of the chartered banks is somewhat restricted by statute. No single institution or affiliated group of institutions is permitted to own more than 10% of a chartered bank. Aggregate foreign ownership may not amount to more than 25% of a bank. It is not always clear, of course, because of nominee holdings, just who are the ultimate beneficial owners of shares in a bank.

The Bank of Nova Scotia reported that at the end of 1976, 45% of its outstanding shares were held by institutions or corporations, 20% were held by 400 Canadian pension funds, 10% by 75 mutual funds, 7% by 30 Canadian insurance companies, 7% by 130 corporations, and 1% by charitable, educational and religious groups. It did not indicate what percentage might be held by trust company accounts.

In recent years the banks have turned to debentures as well as common stock in raising permanent capital. Table 4 also shows debentures outstanding and shareholders' equity. All but two of the banks were making use of debentures and aggregate outstanding debentures were about one third of shareholders' equity. There are no limits on institutional or foreign ownership of bank debentures and a number of debenture offerings have been made in foreign securities markets.

Financial disclosure by the chartered banks is very limited.

Table 5
Assets of Trust and Loan Companies in Canada

As of December 31, 1975
In thousands of dollars

Trust companies	Company assets	Guaranteed trust funds	Assets of estates, trusts and agencies
Provincial (Ontario) Corporations			
Crown Trust	12,729	229,994	643,614
District Trust	5,445	83,960	16,626
Dominion Trust	1,385	5,365	—
Federal Trust	7,241	110,720	25,093
Hamilton Trust & Savings	11,194	146,903	88,811
Industrial Mortgage & Trust	7,320	—	5,253
Lambton Trust	535	—	14,665
Lincoln Trust & Savings	10,036	156,649	37,143
Metropolitan Trust	19,936	267,949	546,210
National Trust	74,122	1,090,302	3,146,579
Ontario Trust	14,024	227,174	7,733
United Trust	22,463	206,147	68,211
Vanguard Trust of Canada	1,066	—	631
Victoria & Grey Trust	59,771	1,123,684	147,549
	247,267	3,648,847	4,748,118
Other Corporations			
Bankers' Trust	1,076	—	36,545
Canada Permanent Trust*	98,263	1,357,872	2,407,591
Canada Trust*	99,739	1,364,994	3,225,625
City Savings & Trust	19,404	258,312	35,731
Continental Trust*	1,194	—	26,550
Co-operative Trust of Canada*	16,774	234,740	166,046
Eaton Trust*	1,181	14,533	156,690
Equitable Trust*	1,388	16,903	18,988
Farmers & Merchants Trust	16,357	237,060	46,914
Fidelity Trust*	9,144	84,157	215,262
Fort Garry Trust	6,014	60,966	27,379
General Trust of Canada	23,884	336,089	1,438,361
Guaranty Trust of Canada*	60,526	1,025,427	712,677
Income Trust*	2,529	24,024	3,581
International Trust	6,882	62,002	670,495
Investors Group Trust	2,294	—	584,560
Montreal Trust	44,251	714,616	5,450,774
Morguard Trust*	3,075	23,864	608,082
Nelcon Trust*	3,750	6,247	804
Premier Trust*	8,238	64,063	6,919
Royal Trust	139,217	2,759,900	11,390,630
Savings & Investment Trust	4,459	63,979	253,137
Standard Trust*	4,753	81,353	53,160
Sterling Trusts*	8,846	150,486	46,885
	583,238	8,941,587	27,583,386
Total - 1975	830,505	12,590,434	32,331,504
Comparative figure for 1974	691,899	10,730,558	28,384,003

Loan Companies	Total assets
Provincial (Ontario)	
Corporations	
Canadian First Mortgage	26,607
Canborough	34,148
Lambton Loan & Investment	117,664
Landmark Savings & Loan	26,538
Municipal Savings & Loan	69,846
Nipissing Mortgage	986
Tordom	361,705
Traders Mortgage	559
	638,053
Other Corporations	
Arteco Mortgage Investment*	20,528
James T. Barnes Mortgage Loan	581
BNS Mortgage*	88,330
Canada Permanent Mortgage*	1,384,182
Crédit-Foncier Franco-Canadien	791,402
Eastern Canada Savings & Loan*	412,493
Fidelity Mortgage & Savings*	68,495
Fidmor Mortgage Investors*	5,923
General Mortgage of Canada*	39,563
Greymac Mortgage*	1,612
Huron & Erie Mortgage*	1,268,067
International Savings & Mortgage*	51,476
Kinross Mortgage*	538,366
Montreal Trust Mortgage	2,764
Morguard Mortgage Investment*	29,114
Nova Scotia Savings & Loan*	288,174
Royal Trust Mortgage	255,068
Roymor	519,811
Seel Mortgage Investment*	6,016
	5,771,965
Total – 1975	6,410,018
Comparative figure for 1974	5,356,927

*Federal Company.
Source: *Report of the Ontario Registrar of Trust and Loan Companies for 1975.*

Table 6
Assets of Trust and Loan Companies Not Doing Business in Ontario

In thousands of dollars

Trust companies	Company assets	Guaranteed trust funds	Assets of estates, trus and agencie
Federal trust companies			
Commercial Trust (Qué.)	732		209,815
Pioneer Trust (Sask.)	1,934	8,959	1,403
Nova Scotia and Manitoba companies			
Acadia Trust (N.S.)	1,196	327	11,504
Atlantic Trust (N.S.)	1,346	21,467	7,031
Inland Trust & Savings (Man.)	2,722	48,981	3,786
Interior Trust (Man.)	582		
North Canadian Trust (Man.)	210		1,025
Regent Trust (Man.)	484		2,340
Total	9,206	79,734	236,904

Loan companies	Total assets
Federal loan companies	
Bomont Mortgage Investment	632
Evangeline Savings & Mortgage	21,417
Graiville Savings & Mortgage	5,224
James T. Barnes Mortgage Loan	581
League Savings & Mortgage	12,228
Settlers Savings & Mortgage	4,704
Nova Scotia company	
Yarmouth Building & Loan Society (N.S.)	316
Total	45,102

Annual reports contain only simplified and condensed balance sheets and operating statements. Disclosure of bank securities portfolio holdings might be of considerable interest. The Financial Post reported that for the first seven months of 1977 banks took up one third of the estimated $6.61 billion of Canadian corporate financing (not including conventional bank loans);[1] banks were also said to have taken up 14% of corporate equity financing.

B. QUÉBEC SAVINGS BANKS

The Montreal City and District Savings Bank is the only Québec savings bank and has been since the disappearance of the Banque d'Économie de Québec in a merger in 1969 with Les Caisses populaires Desjardins. At that time the Montreal City and District became legally entitled to operate beyond Montréal, throughout the province of Québec. Despite its federal charter, however, it may not operate beyond that province. It has about one hundred branches in the Montréal area.

With assets of more than $1 billion, the Montreal City and District ranks after the eight largest chartered banks. At the end of 1976 the bank had almost 60% of its assets invested in mortgage loans. Personal loans stood at about 12% of mortgage loans but were rising fast. The bank is not permitted to make commercial loans. Trust activities are not allowed either but the bank owns a trust company, the Montreal City and District Trustees Ltd., which had estate, trust and agency accounts of $111 million, guaranteed deposits and certificates of $63 million and company assets of $68 million at October 31, 1976.

C. TRUST AND LOAN COMPANIES

There are at least forty-six trust companies and thirty-five loan companies in Canada. These numbers are the totals of the trust companies and loan companies licensed to do business in Ontario, federal companies not doing business in Ontario, and Nova Scotia and Manitoba companies examined by the federal Superintendent of Insurance and not doing business in Ontario. There are fourteen trust companies incorporated in Ontario and seventeen federally incorporated; and there are eight loan companies incorporated in Ontario and twenty federally incorporated.

Table 5 lists the loan and trust companies doing business in Ontario and filing reports with the Ontario Registrar. Table 6

1 *Are Banks Poaching in Corporate Finance?* The Financial Post (Toronto), October 1, 1977, at 35.

adds the federally incorporated and Nova Scotia and Manitoba companies not doing business in Ontario.

Table 5 shows assets of the trust companies. First are assets owned by the trust companies. Second are assets labeled "guaranteed trust funds" which are assets under the control of the companies but segregated as security for the guaranteed certificates issued by these companies. Unlike the chartered banks or banks and trust companies in the United States, the Canadian trust companies do not issue certificates in the form of ordinary unsecured obligations of the company. They issue "guaranteed trust certificates" and segregate the proceeds of these certificates. Finally, the third class includes assets of estates, trusts and agencies administered by the trust companies. In Canada the chartered banks are forbidden to act as trustees and trust companies operate the entire trust business.

In terms of company assets and guaranteed trust funds, the Royal Trust Company is twice the size of the second largest, and Royal Trust together with the next five companies in size clearly dominate the industry. In terms of trust assets, Royal Trust is again twice the size of the second largest and six companies (but not the same six) dominate the industry.

Of the loan companies, two clearly stand out in size. These are the Canada Permanent Mortgage Corporation and The Huron & Erie Mortgage Corporation.

D. CREDIT UNIONS

Credit unions (and caisses populaires, in Manitoba and Québec) constitute an important financial institution in at least six provinces. All are organized under provincial statutes. Table 7 shows total assets and memberships by province. Primarily savings institutions, with assets consisting chiefly of loans including mortgage loans, credit unions have begun to operate as full service financial institutions. In British Columbia provincial and municipal deposits in credit unions averaged $50 million over the last half of 1976. The B.C. Central Credit Union League reported in 1976 plans to borrow $20 million to $80 million in 1977 through a debenture issue. Credit unions offer chequing accounts, and credit union cheque clearings have recently accounted for about 20% of all cheque clearings in Alberta, British Columbia and Manitoba and 40% in Saskatchewan.

Credit unions have banking and trust company affiliations. In Québec credit unions own 25% of The Provincial Bank of Canada. Western Canadian credit unions organized their own chartered bank in 1976 – the Northland Bank – which operates in Manitoba,

Alberta and Saskatchewan. Co-operative Trust is a federally incorporated trust company, owned entirely by credit unions and cooperatives. Unlike Northland Bank, which is a wholesale institution, Co-operative Trust does a general trust company business in all provinces except Québec.

The provincial associations are owned by their locals, accept deposits from the locals, and make loans to the locals. They function essentially as a central bank for the locals, although they engage at times in quite different activities as we shall see. The federal association, the Canadian Co-operative Credit Society Ltd., which was formed in 1973, serves as a central bank for the provincial associations and in 1978 announced plans to raise funds in the Canadian and international capital markets. Table 8 shows assets and membership of the credit union industry in Canada overall, and the Québec portion of the industry.

There is also a National Association of Canadian Credit Unions which is not itself a financial institution but which serves as a trade association. At the end of 1975 its membership included about 2,500 credit unions with over $7 billion in assets.

Credit unions in Québec numbered approximately 1600 at the end of 1976 – the largest number in any province. Table 8 shows the six central credit unions in Québec to which the locals belong. These credit unions are generally known as "caisses populaires" and the members of the largest central are known as "Caisses Desjardins" after Alphonse Desjardins who established the first caisse populaire at Lévis in 1900, and who persuaded the Québec legislature to adopt a credit union statute in 1906. Other than members of the Québec Credit Union League, the Québec credit unions do not belong to the Canadian Co-operative Credit Society.

The bulk of credit union assets consists of loans. The Caisses d'entraides économique are unique in making local business loans rather than residential mortgage loans. Only the Saskatchewan and Québec locals own significant amounts of common stock. The Québec centrals also hold common stock and not always for purely investment purposes. In March 1977 the president of the Fédération de Québec des Caisses populaires Desjardins (the dominant central, as table 8 shows) disclosed that his central had purchased 228,000 shares of The Montreal City and District Savings Bank (11.4% of the outstanding shares) on the initiative of The Provincial Bank of Canada and with the intention of selling them to Provincial Bank so that the latter could bring about a merger with Montreal City and District. (The caisses own about 25% of Provincial Bank.) Provincial Bank itself had apparently purchased another 200,000 shares (10% of shares outstanding and the maximum permissible holding by one person). The sale, and merger, did not

Table 7
Credit Union Statistics[a]

1975 and 1976
In millions of dollars

	Number of credit unions		Number of members	
	1975	1976	1975	1976
British Columbia	178	176	595,000	668,089
Alberta	200	191	285,000	316,345
Saskatchewan	247	245	426,000	456,381
Manitoba	194	191	292,000	314,000
Ontario	1,260	1,208	1,600,000	1,650,000
Québec	1,583	1,610	3,975,000	4,262,000
Nova Scotia	126	127	134,000	150,000
New Brunswick	146	138	143,000	178,671
Prince Edward Island	13	13	18,000	18,095
Newfoundland	24	14	7,100	7,806
Yukon and Northwest Territories	4	5	2,850	3,100
Total	3,975	3,918	7,477,950	8,024,487

Savings		Loans		Assets	
1975	1976	1975	1976	1975	1976
$ 1,409	$ 1,868	$ 1,280	$ 1,667	$ 1,550	$ 2,034
490	658	431	580	550	730
860	1,392	791	992	1,341	1,553
578	692	481	594	637	943
2,100	2,300	1,550	1,900	2,200	2,700
5,942	7,060	3,780	4,843	6,310	7,516
112	133	99	121	122	150
119	159	106	142	132	174
12	13	14	16	17	19
6	9	5	9	6	10
4	4	5	4	5	4
11,632	14,288	8,542	10,868	12,870	15,833

a. Includes Caisses Populaires.
Source: *The Credit Union Financial System in British Columbia*, published by the B.C. Central Credit Union League Ltd., May 1977.

Table 8
Credit Unions in Canada

Assets as of fiscal year end, 1976
In millions of dollars

	Assets of national and provincial bodies	Number of members	Assets of members
Members of the Canadian Co-operative Credit Society Ltd.			
Canadian Co-operative Credit Society Ltd.	$ 54		
B.C. Central Credit Union League Ltd.	367	176	$2,035
Credit Union Federation of Alberta Ltd.	99	191	730
Co-operative Credit Society of Manitoba Ltd.	111	162[a]	713
Brunswick Credit Union Federation Ltd.	2	138	174
Newfoundland Co-operative Services Ltd.	0.085[b]	16	10
Nova Scotia Credit Union League Ltd.	33	127	150
Ontario Credit Union League Ltd.	246	1,081	2,400
P.E.I. Credit Union League Ltd.		13	19
Quebec Credit Union League Ltd.	15	89	124
Saskatchewan Co-operative Credit Society Ltd.	386	245	1,553
Northwest Territories Credit Union Central		4	2
Whitehorse Credit Union League Ltd.		1	2
Québec[c]			
Fédération de Québec des Caisses populaires Desjardins	25	1,245	6,278
Fédération de Montréal des Caisses Desjardins	56	34	475
Fédération de Caisses d'économie du Québec	46	138	222
Quebec Credit Union League Ltd.	15	89	124
Fédération des Caisses d'établissement du Québec	3[b]	12	77[b]
Fédération de caisses d'entraide économique du Québec	30	55	428[d]

a. About 30 caisses populaires, with assets of $70 million, belong to Centrale des Caisses populaires du Manitoba, with assets of $11 million.
b. As of March 31, 1977.
c. As of December 31, 1976.
d. As of May 1977.

take place. Montreal City and District was able to enlist the support of investors who purchased 30% of the outstanding shares and were prepared to block a merger.

The Canadian government *White Paper on Banking Legislation* proposed in 1976 that credit union holdings of the stock in a chartered bank or Québec savings bank be limited so that the combined holdings of a central, federation or regional unit and its associated credit unions or caisses populaires would not exceed 25%. The Senate Banking, Trade and Commerce Committee recommended a 10% limitation.[2]

E. LIFE INSURANCE COMPANIES

In 1975 there were 166 life insurance companies doing business in Canada, of which 83 were Canadian companies, 65 were U.S. companies, 9 were British and 9 were European. Of the 166, 25 were registered under provincial law and 141 under federal law. The latter accounted for 94% of total life insurance in force. Assets of the federally registered companies were $24,095 million at the end of 1975.

In Ontario in 1975 there were 128 life insurance companies, 6 companies writing both life and casualty insurance, and 38 fraternal societies, all but one of which write life insurance.

In recent years life insurance companies have taken on the management of segregated funds, chiefly pension funds. In this business they compete with trust companies, brokers, and investment counselling and management firms and it is here that growth prospects for life insurance companies seem chiefly to lie.

Table 2 gives a breakdown of the investments by major categories of Canadian life insurance companies. More detailed information is not publicly available. The companies all supply annual lists of all of their investments and of their investment transactions to the superintendents of insurance, but these listings are kept confidential. Some information came to light in the submission to the Royal Commission on Corporate Concentration in 1976 by the Canadian Life Insurance Association. The submission noted the legal limitations on investments of life insurance companies, in particular the prohibition against a Canadian life insurance company investing in more than 30% of the common stock of any one corporation. The submission stated that "a survey of member companies reveals that an individual company owned 10% to 30%

2 *Standing Senate Committee on Banking, Trade and Commerce, Twelfth and Final Proceedings on the White Paper on Canadian Banking Legislation, Report of the Committee*, issue No. 44, at 44:74-44:75 (June 28, 1977).

of a Canadian corporation's common stock at the end of 1974 in twenty-seven cases. Nine were real estate corporations and only eight of all the corporations were listed on a Canadian stock exchange. The twenty-seven cases were spread among fifteen life insurance companies."[3]

F. MUTUAL FUNDS

There are two kinds of investment companies. The so-called "closed-end" funds raise money by offering shares to the public just as any corporation does, and invest that money in a portfolio of securities. The shares of the funds themselves are traded as are shares in any corporation and may even be listed on a stock exchange. The "open-end" funds, or mutual funds, likewise raise money from the public and invest the money in a portfolio of securities. But unlike the closed-end funds, the mutual funds are continuously offering new shares to the public and redeeming shares from shareholders who wish to withdraw their money. There may be a small trading market for mutual fund shares but most individuals buy new shares from a fund when they wish to invest in it and return their shares for redemption when they wish to sell out. The price at which new shares are sold and old shares redeemed is established by the net asset value per share of the fund which is just the net asset value of the entire fund divided by the number of shares outstanding. There may in addition be a sales charge or a redemption charge on the purchase or redemption.

A large number of Canadian mutual funds representing the majority of fund assets are members of The Investment Funds Institute of Canada. Table 9 gives a breakdown of the membership, by size. As of March 30, 1977, the number of member funds stood at seventy-five, with total assets of $1,836 million. There were one hundred non-member funds with total assets of $1,269.1 million. Total assets for the industry were $3,105.7 million.

The bulk of the portfolio assets of the mutual funds consists of stocks and bonds. A few funds, however, specialize in short-term securities. And four members of the Investment Funds Institute specialize in mortgages. The largest of these, Investors Mortgage Fund, had assets of $132.3 million at the end of 1976. The three others had aggregate assets of $22.9 million.

3 Canadian Life Insurance Association, Submission to the Royal Commission on Corporate Concentration (1976), at 19.

Table 9
Investment Companies: Assets and Number of Members of The Investment Funds Institute of Canada

As of December 31, 1976
In millions of dollars

	Number of funds	Total assets
Over $200 million	2	$ 430
$100–199 million	4	512
$50–99 million	2	148.9
$25–49 million	6	209.6
$10–24 million	21	344.8
$5–9 million	15	107.9
$1–4 million	19	53.6
Under $1 million	5	2.9
Total	74	1,809.7

Source: The Investment Funds Institute of Canada.

G. PENSION FUNDS

As of 1970 about 2.8 million Canadian workers were members of over 16,000 pension plans. As table 2 shows, the assets of trusteed pension funds were worth about $18 billion at the end of 1976. Over half the assets – $9.3 billion – were held by government funds, and the balance by private industry funds. The Canada Pension Plan with $9.4 billion in assets, and the Québec Pension Plan with $4 billion, bring total pension fund assets in Canada to over $30 billion.

Private pension funds are significant buyers of Canadian equities. Government funds own a substantial number of equities but are much more heavily invested in bonds, particularly provincial and municipal bonds. The use of public pension funds to finance local government needs is a feature of Canadian and American capital markets.

1. *Canada Pension Plan*

The Canada Pension Plan began operations in January 1966. All Canadian employees are required to contribute 1.8% of contributory earnings which in 1976 meant earnings over $800, up to and including $8,300. Employers are required to make a matching contribution and the self-employed are required to contribute 3.6% of contributory earnings.

A rather small portion of the fund's assets representing working capital is invested in Canadian government securities. The remainder is loaned to the provinces with each province receiving the contributions originating in that province. The loans take the form of twenty-year nonnegotiable bonds bearing interest at the average market yield of twenty-year Government of Canada bonds at the time of issue. (The bonds are, however, callable before maturity to meet benefit payments.) Table 10 shows investment of the funds from 1966 through 1976. The investments in Québec bonds are small because these amounts relate only to federal employees resident in Québec. (Other employees in Québec do not contribute to the Canada Pension Plan; they contribute instead to the Québec Pension Plan.) The interest income for 1976 was about 7.1% of the average balance of the fund during the year.

An interesting review of the investment policy of the Canada Pension Plan, with recommendations for change, was published in 1975.[4] The Advisory Committee of the Canada Pension Plan noted

4 Advisory Committee of the Canada Pension Plan, The Rate of Return on the Investment Fund of the Canada Pension Plan (June 1975).

that the plan represented 19.5% of all Canadian personal savings in the five years ended March 31, 1974, and had been a big factor in overall Canadian economic expansion.[5] It considered the possibility of a managed portfolio (as in the case of the Québec Pension Plan, described below), but concluded that automatic loans to the provinces were appropriate. However, the advisory committee recommended an interest charge based on provincial bond rates.[6]

2. *Québec Pension Plan*

The investment operation of the Québec Pension Plan is very different from that of the Canada Pension Plan. The Québec plan is administered by the Régie des rentes de Québec which remits the plan's collections to the Caisse de dépôt for investment.

The Québec Pension Plan began at the same time as the Canada Pension Plan and its assets were $4 billion at the end of 1976. The Caisse de dépôt was established in 1965 to invest funds from a number of government units in Québec. Total assets of the caisse at the end of 1976 were $5.3 billion, of which the Québec Pension Plan accounted for 75%. Workmen's compensation, government employee retirement funds, and construction industry pension funds accounted for another 21%.

The Caisse de dépôt has been highly regarded as a government agency relatively free of political interference and investing in corporate equities as well as corporate and government bonds, much as a private investment company might. As of the end of 1977 the holdings of its "general fund", which is essentially the Québec Pension Fund, were as shown in table 11.

Segregated funds consisted of $478.0 million in bonds, $221.3 million in stocks, $225.0 million in mortgages, and $98.3 million in short-term investments.

H. CONCLUSIONS AND POLICY IMPLICATIONS

Institutional interest in corporate common stocks is a matter of great importance to the Canadian economy. As we shall see in chapter V, individuals have been withdrawing from the stock market in recent years with institutions taking their place. If equity capital is to be available to Canadian industry in future years, it is crucial that institutions be willing and able to furnish it.

Encouraging institutional acquisition of equities, of course,

5 *Id.* at 8.
6 *Id.* at 25.

Table 10
Canada Pension Plan Investment Funds: Investments by Province

Fiscal years 1965–66 to 1975–76
In millions of dollars

	Securities of or guaranteed by					
	Nfld.	P.E.I.	N.S.	N.B.	Qué.	Ont.
1965–66	0.7	0.1	1.2	1.0	—	20.1
1966–67	11.0	1.9	21.4	16.7	0.4	332.6
1967–68	12.0	2.3	25.2	19.3	1.9	375.9
1968–69	14.2	2.9	29.2	21.8	2.4	412.0
1969–70	15.6	3.2	31.6	24.2	3.1	445.8
1970–71	16.8	3.5	34.0	25.8	5.1	476.0
1971–72	17.6	3.6	35.7	26.8	6.6	498.3
1972–73	19.0	3.8	38.6	28.8	8.0	536.4
1973–74	21.7	4.3	43.8	32.8	8.1	606.6
1974–75	25.8	5.3	50.9	38.3	7.9	701.8
1975–76	29.4	6.0	57.3	43.2	8.0	784.1
Total	183.8	36.9	369.0	278.7	51.5	5,189.6

Man.	Sask.	Alta.	B.C.	Canada	Total	Cumulative total
2.1	1.4	3.1	5.0	0.1	34.8	34.8
34.9	24.5	51.1	84.4	1.8	580.7	615.5
39.4	29.7	59.2	96.6	3.8	665.3	1,280.8
42.3	35.9	68.4	107.5	5.6	742.2	2,023.0
47.7	40.4	77.1	117.2	4.1	810.0	2,833.0
51.5	42.9	82.3	125.1	5.4	868.4	3,701.4
53.7	42.7	87.1	131.2	6.5	909.8	4,611.2
57.4	43.2	94.6	141.5	7.1	978.4	5,589.6
64.5	47.8	108.7	161.7	7.9	1,107.9	6,697.5
74.5	55.6	126.6	189.1	9.1	1,284.9	7,982.4
83.4	62.6	143.4	213.9	10.2	1,441.5	9,423.9
51.3	426.7	901.6	1,373.3	61.7	9,423.9	

Source: *Canada Pension Plan, Report for the year ending March 31, 1976*, at 32.

Table 11
Caisse de dépôt General Fund

Assets at market value as of December 1977 In millions of dollars	
Bonds	
Government of Canada	80.5
Government of Québec	2,453.9
Guaranteed by provincial grants	150.9
Municipal and school	292.4
Corporate	438.5
	3,416.2
Equities	671.3
Mortgages	257.4
Real estate	25.4
Short-term	326.9
Total	4,697.2

Source: Caisse de dépôt et placement du Québec.

involves far more than securities regulation. Tax policy and statutory limitations on holdings of institutions are important. So is the relative role of private and public pension plans.[7] There is a growing fear in both Canada and the United States that public pension plans may discourage private saving that is needed for economic growth. Defenders of the Canada Pension Plan would argue, of course, that it finances necessary public sector benefits and reduces the competition for capital between the provinces and the private sector. The Québec Pension Plan perhaps stands as the best example of a government plan that is channeling savings directly into productive private sector investment, although equity investments are less than 15% of the plan's assets.

Within the jurisdiction of a regulatory commission, however, there are also some policy implications. Regulation that makes institutional acquisition of equities difficult or expensive may be harmful to the economy. The use of "exempt purchaser" status to avoid expensive disclosure formalities may be helpful. Decisions on brokers' commission rates, particularly with respect to discrimination in the rate structure between individual and institutional customers, should take into consideration the importance of institutions as stock buyers. The tendency is always to deplore the exit of individual investors from the stock market, and to approve rate structures that will lure them back. The result, unfortunately, may be simply to discourage both individuals and institutions. The same issue arises in connection with possible limitations on institutional ownership and trading of common stocks and again in connection with the provision of market-making services which may be aimed at either institutions or individuals.

To the extent that a regulatory commission or a regulatory statute may affect the securities-related activities of financial institutions, the potential value of the branch network of the larger chartered banks should not be ignored. It may well be that many of the needs of investors could be more efficiently served through bank branches than through the securities industry. In a few provinces credit unions offer the same opportunity. Although the credit unions are not organized as multiple branches of a single organization, the very large groups of local credit unions belonging to the same central credit union offer a potential very similar to that of the bank branch networks.

Finally, a regulatory commission is presented with two policy questions involving disclosure. Should the financial institutions

7 A particularly critical issue is whether private pensions are to be indexed and if so, what effect this might have on pension fund investment in equities. *See* J.

(apart from mutual funds) continue to be free of significant disclosure requirements when they raise capital from the public? And considering the substantial concentration of security holdings in these institutions, should there be some disclosure of institutional holdings, trading and other portfolio practices? This latter question is particularly difficult to answer in view of the need, referred to above, to encourage institutional stock ownership. It is a question we shall come back to in chapter IV.

Chapter II
The Canadian Securities Industry

It is difficult to assemble a complete picture of the securities industry in Canada. Statistics have been compiled at various times, in 1970 by the Moore Committee – which studied the requirements and sources of capital and the implications of nonresident capital for the industry (see note 31) – and in 1975 by Professors D. Shaw and R. Archibald for their study for the Toronto Stock Exchange, but even these either dealt with only a part of the industry or relied a good deal on guesswork.

A. REGISTERED PARTICIPANTS

A list of categories of registrants with the Ontario Securities Commission (OSC) (table 12), as of May 30, 1977, gives an idea of the variety of participants in the Canadian securities industry:

A "broker" is defined in the regulations under the Ontario Securities Act as a member of the Toronto Stock Exchange (TSE), and acts exclusively as an agent. The nine registered brokers carried on no securities trading other than on the exchange, although at least four were closely affiliated with investment dealers. In total, seventy-one firms were registered as members of the TSE, including firms performing more than a broker function.

An "investment dealer" is defined as a member of the Investment Dealers Association of Canada (IDA) and may trade as agent or as dealer. Investment dealers handle most of the bond business in Canada, as well as underwriting industrial equities. There were sixty-one registered investment dealers of which forty-nine were also members of the TSE.

A "broker-dealer" is defined as a member of the Broker-Dealers' Association of Ontario and may trade as a broker or dealer. These firms are not members of IDA, although one in the

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Pesando & S. Rea, Jr., Public and Private Pensions in Canada (1977) (especially ch. 4 and app. A.).

Table 12
Various Registrants with the Ontario Securities Commission

As of May 30, 1977

Category	Number registered
Broker (member TSE)	9
Investment dealer (member IDA)	12
Broker-dealer (member BDA)	12
Broker and investment dealer (TSE and IDA)	49
Broker and broker-dealer (TSE and BDA)	1
Broker and securities dealer	12
Securities dealer	10
Mutual fund dealer	19
Scholarship plan dealer	1
Security issuer	13
Underwriter	5
Investment counsel	8
Securities adviser	1
Investment counsel and portfolio manager	41
Total	193

list in table 12 was also a member of the TSE. Broker-dealers for the most part underwrite and deal in new issues of mining and oil stocks. There were thirteen registered as of May 30, 1977.

A "securities dealer" is registered to trade as a broker or dealer but is not a member of any of the three organizations referred to above. Twelve members of the TSE were also registered as securities dealers so that they could carry on a dealer as well as a broker business. About half of the ten firms registered solely as securities dealers were affiliates of foreign securities firms.

A "mutual fund dealer" acts exclusively to sell mutual fund shares and most of the nineteen registrants were mutual fund management companies or affiliates of management companies selling shares in the funds they managed.

A "scholarship plan dealer" is registered exclusively to trade in the securities of scholarship or educational plans or trusts.

A "securities issuer" is registered to trade only in securities of its own issue without acting through a registered broker or dealer. Most of the thirteen registrants were either mutual funds issuing shares directly to investors, or finance companies issuing securities directly.

An "underwriter" is registered to act as either principal or agent in the underwriting process but registration solely as an underwriter does not confer the right to deal directly with the public. Some other class of registrant must carry out this stage of an underwritten offering. Two of the five registered underwriters were affiliates of chartered banks and one was an affiliate of a U.S. investment banking firm.

A "securities adviser" gives general advice on specific securities, usually by means of a market letter, while "investment counsel" serve the particular needs of individual clients. "Portfolio managers" have discretionary authority to manage the portfolios of clients.

A further category of "registrant" that is of some interest, although it is not really part of the securities industry, is the "exempt purchaser", permitted to purchase unregistered new issues of securities so that an offering limited to exempt purchasers does not require a prospectus. Most exempt purchasers are pension funds and mutual funds. Some are foreign insurance companies (domestic insurance companies automatically enjoy the benefits of an exemption). In early 1977 there were fifty-three exempt purchasers registered with the OSC.

Table 13 lists the numbers of registrants in all provinces, the Yukon and the Northwest Territories. The greatest concentration was in Ontario, Québec and British Columbia.

Table 13
Number of Registrants, Registered with Various Provincial and Territorial Authorities

As of spring, 1977

Category	Alta.	B.C.	Man.	N.B.
Members of Toronto, Montreal, Vancouver or Alberta stock exchanges[a]	18	39	18	10
Members of Investment Dealers Association of Canada[a]	25	24	19	12
Members of Broker-Dealers' Association of Ontario[a]				
Broker-dealers (petroleum and natural gas leases)				
Other brokers and dealers	7	3	8	7
Investment counsel and securities advisers	19	23	2	1
Mutual fund broker or dealer	16	19	8	8
Scholarship plan broker or dealer	1	1	1	2
Underwriter		6	2	4
Security issuer	15	29	6	1
Exempt purchaser				
Unidentified		4	13	
Total	101	148	77	45

fld.	N.W.T.	N.S.	Ont.	P.E.I.	Qué.	Sask.	Yukon
	1	16	71	11	57	11	2
)	1	15	61	10	49	11	1
		6	13	2			
						55	
		8	10	4	14	1	
			59		34	4	
	1	11	28	7	14	13	
	1	1	1	1	2		1
	1	3	7	3		1	
		1	13			2	1
			53[b]				
		4					
1	5	65	316	38	170	98	5

a. There is some overlap among these three memberships.
b. Locations: Ontario 38; Manitoba 7; Québec 5; U.S.A. 3.

Table 14
Value of Trading on Canadian Stock Exchanges

1964–77
In millions of dollars

	Toronto		Montreal		Vancouver	
1964	$3,056.6	69.3%	$1,122.8	25.5%	$219.8	4.9%
1965	3,199.1	67.1	1,252.0	26.3	302.2	6.3
1966	2,877.2	67.9	1,006.4	23.8	319.0	7.5
1967	3,521.3	67.7	1,302.7	25.2	337.6	6.5
1968	5,015.0	69.4	1,550.2	21.4	633.3	8.8
1969	5,765.2	72.5	1,628.2	20.5	477.7	6.0
1970	3,653.8	68.6	1,205.0	22.1	454.4	8.5
1971	4,715.7	69.2	1,598.4	23.4	488.4	7.2
1972	6,258.2	68.7	2,057.3	22.6	782.5	8.6
1973	6,737.1	71.7	2,174.0	23.1	483.3	5.1
1974	4,523.5	68.6	1,598.0	24.2	464.8	7.1
1975	4,089.0	70.4	1,384.7	23.8	314.5	5.4
1976	5,093.0	73.3	1,483.6	21.3	328.3	4.7
1977	6,044.8	76.8	1,374.2	17.5	395.1	5.0

Alberta		Winnipeg		Total
$ 5.9	0.1%	$2.8	—	$4,408
9.5	0.2	3.6	0.1%	4,766
32.0	0.8	2.2	—	4,236
29.3	0.6	2.4	—	5,193
27.8	0.4	2.6	—	7,228
76.6	0.9	5.8	—	7,954
17.0	0.8	0.8	—	5,331
11.8	0.2	0.8	—	6,815
6.5	0.1	0.8	—	9,105
7.1	0.1	0.6	—	9,402
5.7	0.1	0.6	—	6,593
18.3	0.3	1.8	—	5,808
46.8	0.7	1.0	—	6,953
58.5	0.7	0.8	—	7,873

Source: Toronto Stock Exchange.

B. SELF-REGULATORY ORGANIZATIONS

There are seven principal self-regulatory organizations within the Canadian securities industry: the Investment Dealers Association of Canada, the Broker-Dealers' Association of Ontario, and five stock exchanges: Toronto, Montreal, Vancouver, Alberta and Winnipeg. The last two are quite small, and in 1977 accounted for only about 1% of trading on all five exchanges. As table 14 shows, the Toronto Stock Exchange is the dominant market. A minor organization in terms of self-regulation is The Investment Funds Institute of Canada.

As of early 1977, there were 75 Toronto Stock Exchange member firms, of which 30 were also members of the Montreal exchange, 6 were members of the Vancouver exchange, and 15 were members of both the Montreal and Vancouver exchanges. Another 16 firms were members only of the Montreal exchange (plus 3 with limited trading privileges); 22 more were members of the Vancouver exchange alone; and another was a member of both the Montreal and Vancouver exchanges. Of 26 members of the Alberta Stock Exchange (ASE), 23 belonged to other exchanges. In all, these numbers represent 120 different member firms.

The Investment Dealers Association of Canada had 89 members in 1977, of which 78 were members of the Toronto, Montreal or Vancouver exchanges. And the Broker-Dealers' Association of Ontario had 13 members, of which one was a member of the TSE. These two dealer associations bring the total number of brokers and dealers to 143.

In 1975 a joint industry committee provided a tabulation of budgets and staff for the four largest organizations (table 15).

1. *Toronto Stock Exchange*

The Toronto Stock Exchange is the major self-regulatory organization in the Canadian securities industry. There are 126 seats on the exchange, but membership has declined in recent years, from a peak of 100 firms in 1969 to 75 in 1977. The value of a membership has also declined, as shown in table 16. In general, the value of a seat has followed the volume of trading but the relationship has not been quite as close as one might have expected, as is shown in figure 1.

Member firms of the TSE employed 4,404 salespeople (registered representatives) in May 1976, down from a peak of 5,064 in 1973 and up from 2,516 in 1965. The average annual growth from 1965 to 1976 was 5.2% a year. Branch offices grew from 276 in 1965 to 457 in mid-1976 (peaking in 1973 at 483) at an average rate of

Table 15
Budget and Staff of the Four Largest Securities Industry Organizations

1975
In thousands of dollars

	Budget	Staff
Investment Dealers Association of Canada	$ 800	24
Toronto Stock Exchange	4,500	206
Montreal Stock Exchange	2,000	79
Vancouver Stock Exchange	1,500	50

Table 16
Price Range of Seats on the Toronto Stock Exchange

1963–77
In thousands of dollars

	High	Low	Number of transactions
1963	$ 71	$ 60	2
1964	75	70	5
1965	105	90	3
1966	105	90	2
1967	92	65	7
1968	98	98	1
1969	125	125	14
1970	132.5	115	4
1971	95	80	2
1972	90	60	7
1973	90	87	3
1974	nil	nil	nil
1975	39	20	10
1976	30	20	8
1977	20	15	7

Source: Toronto Stock Exchange.

Figure 1
Average Seat Prices and Volume of Trading on the Toronto Stock Exchange

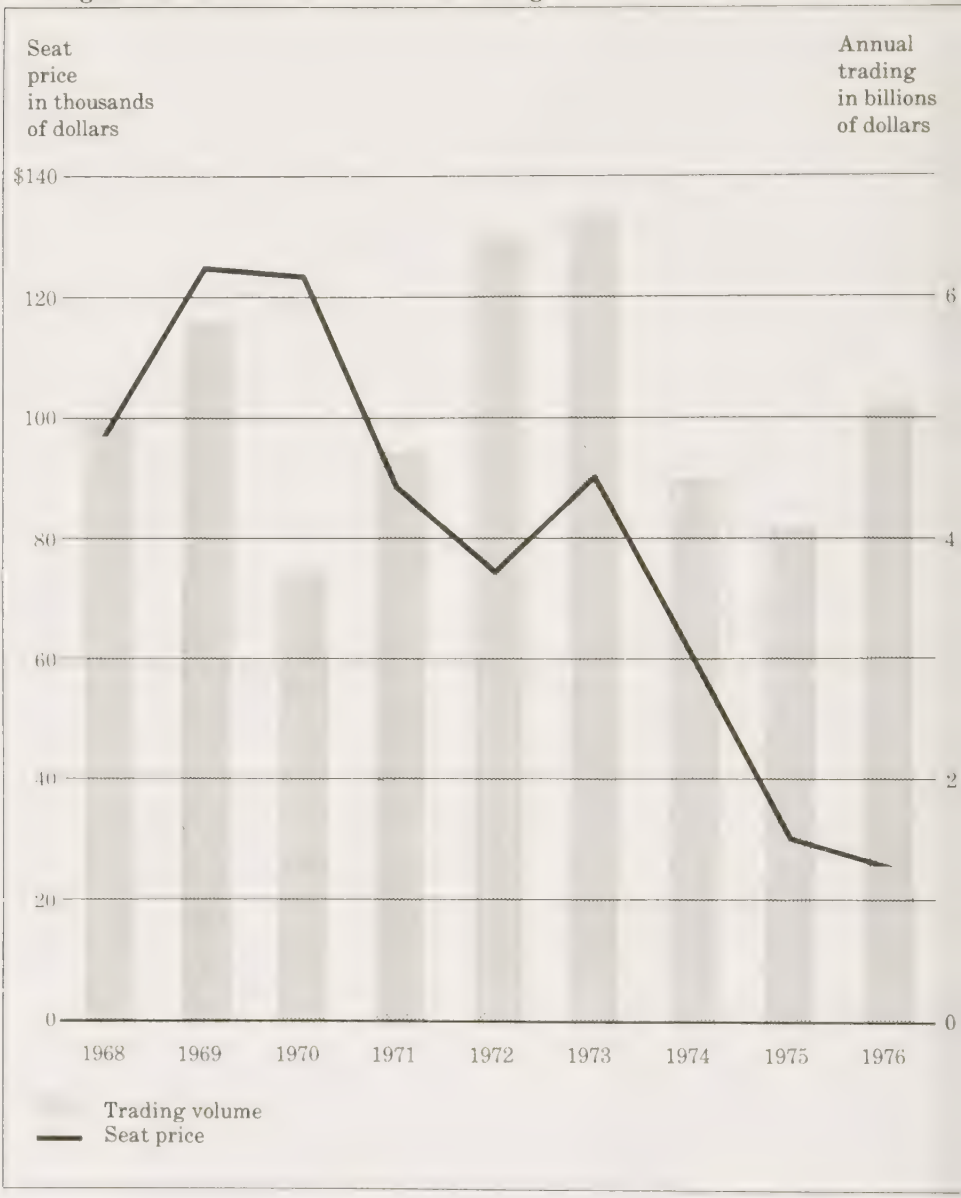


Table 17
Average Profit of Toronto Stock Exchange Members Before Income Tax as a Percent of Capital

As of year ending March 31, 1968–76	
1968	20.0%
1969	40.3
1971	16.4
1972	28.0
1973	34.5
1974	12.2
1975	16.4
1976	24.8

4.7% a year. Volume on the exchange measured in value of transactions grew at 2.5% a year from 1965 to 1975. The number of issues listed on the exchange grew by 1% a year over this time but the number of transactions declined by an average 5.6% a year.[8] It seems possible that as of 1977 there were still too many salespeople in the industry. There has been a trend to larger transactions in value and number of shares, probably as the result of increasing institutionalization of the market.[9]

The exchange has been disappointed in the value of trading in recent years but there seems little to support its estimate of what is "normal" trading. In 1975, trading on all exchanges in Canada totalled $5.8 billion. The exchange has said that $15.7 billion would have been consistent with historic trends[10] and would have been 9.7% of Canada's Gross National Product. But volume has reached this percentage of GNP in only two years – 1968 and 1969. While it is true that actual 1975 volume was only 3.6% of GNP, the lowest percentage in at least sixteen years, it is not clear what a "normal" percentage is.

Average profit of members before taxes as a percent of capital is shown in table 17.[11]

These are returns on equity and subordinated debt rather than on equity alone, but for most firms that use it, subordinated debt is very similar to equity provided by owners.

2. *Montreal Stock Exchange*

The Montreal Stock Exchange (MSE), as the volume and budget statistics have shown, is much smaller than the Toronto exchange. It has seen about the same proportionate decline in memberships and in registered representatives. (A seat on the MSE sold for only $2,000 in early 1976.) But as the volume statistics in table 14 indicate, Montreal has been losing its share of the dollar value of trading in Canada. Montreal does somewhat better in senior industrial stocks that are listed on both exchanges (26.7% of volume in 1975) than in interlisted junior industrials (1.5% of volume in 1975).[12]

Competition between the Toronto and Montreal exchanges has extended over the years to a variety of protectionist rules. In

8 H. McKay, Evolution of the Canadian Securities Market with Particular Focus on the Equity Market 120–49 (Toronto Stock Exchange 1976).

9 This trend is discussed in ch. V *infra*.

10 H. McKay, *supra* note 8, at 123.

11 Computed from tables 6 and 7 in H. McKay, *supra* note 8, at 154–55.

12 Quebec Securities Commission Task Force, Commission Rates in the Securities

1969 the Quebec Securities Commission announced Policy Statement No. 4 which required, subject to a broker's duty to obtain the best execution for a customer, that orders originating in Québec in Montreal-listed stocks be executed in Montreal.[13] On its face, the statement was probably not unreasonable, and enforced literally according to its terms, it would probably have made little difference.

Next, the Montreal exchange stopped enforcing its "cross interference" rules. These are contained in section 6169 of rule II of the Montreal exchange and essentially restrict the ability of a member to "cross" a buy order with a sell order at the same price. Under the rules other members bidding or offering at the same price as that for a proposed cross, were entitled to trade at that price up to 15% of the proposed cross. The halt to enforcement of the cross interference rules made the Montreal exchange an attractive place for crosses and drew business from Toronto. The Toronto Stock Exchange responded by suspending section 11.19 of its by-laws, the counterpart of the Montreal section 6169, so that trading conditions were equalized.

Then the Quebec Securities Commission brought proceedings against a Toronto-based member firm under Policy Statement No. 4, indicating that the policy was to be interpreted so as to require Montreal member firms to bring a satisfactory proportion of their Québec-based business to the Montreal floor. The Toronto Stock Exchange was concerned that this interpretation would seriously

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INDUSTRY 65-72 (June 1976). Over 680 stocks are listed on both exchanges, and almost 600 of them are "senior industrials".

13 The text of the policy statement was:

> "The Commission under Section 2 of the Securities Act is charged with the supervision and control of the securities business in the Province of Québec.
> "In the case of shares quoted on an Exchange recognized by it (*i.e.*, the Montreal Stock Exchange and the Canadian Stock Exchange), the Commission is of the opinion that it is in a better position with respect to the secondary market to exercise a continued supervision of the Securities business in the Province, if at all possible, purchases and sales which originate in the Province of Québec are transacted within the Province.
> "On the other hand the Commission is aware that some securities are listed both on an Exchange recognized by it and other Exchanges in Canada or elsewhere and that the first duty of a broker towards his client is to obtain for him the best price possible.
> "In order to reconcile these two requirements the Commission has decided that buy or sell orders originating in this Province for shares listed on an Exchange recognized by it should be executed on the floor of such an Exchange, if possible, and that all things being equal and taking into account the broker's duty towards his client to obtain for him the best execution possible, transactions should take place on the floor of that Exchange.
> "Brokers must at all times be prepared to explain any failure to conform with this policy."

divert trading. It responded with section 11.19(2) of its by-laws which prohibits a member (acting as principal) from reversing on another exchange any part of a position acquired on the TSE, and from reversing on the TSE any part of a position acquired on another exchange.[14]

The Montreal exchange had derived no net benefit from this contest of rules and in 1977 the Quebec Securities Commission withdrew Policy Statement No. 4.[15] The Montreal exchange clearly hoped that Toronto would abolish section 11.19(2) but the TSE delayed, while awaiting resolution of matters relating to short sale rules and restrictions on the trading of members' accounts operated by traders on the exchange floors. Toronto was particularly concerned about a new category of member on the Montreal exchange, a member trading for himself, free of any specific obligations to serve the quality of the market but adding his capital and trading to the market's apparent benefit. Registered traders on the Toronto exchange are subject to a number of restrictions that would put them at a disadvantage in competition with the Montreal members.[16] Perhaps more important, a Toronto registered trader, absent new rules, might avoid the TSE restrictions by setting up a partner on the MSE floor. In early 1978, section 11.19 was amended to expand the exemptions from the arbitrage prohibitions, which relaxed the competition between the two exchanges.

3. *Vancouver Stock Exchange*

The Vancouver exchange has in recent years become Canada's speculative mining stock market. Its self-regulatory function was substantially restricted in August 1977 when prospectuses for primary offerings through the exchange were transferred from the jurisdiction of the exchange to that of the British Columbia Superintendent of Brokers.

14 Toronto Stock Exchange, by-law 11.19(2), 3 CCH Can. Sec. L. Rep. ¶ 89-409. Except in executing orders for the accounts of customers, members are prohibited from making bids, offers, purchases, or sales of a security on the exchange to reduce, hedge or otherwise offset a position taken on another stock exchange in Canada. Any position resulting from a purchase or sale of a security on the exchange, except in executing orders for the accounts of customers, shall not be reduced, hedged or otherwise offset on another stock exchange in Canada.

15 8 QSC Bull., No. 35 (Decision No. 5316, September 6, 1977).

16 There is apparently not much enthusiasm for restoration of the "cross interference" rules, partly because this might encourage the taking of crosses to the United States.

4. *The Investment Funds Institute of Canada*

This organization was formed in 1962 as the Canadian Mutual Funds Association, and acted as a self-regulatory body until 1976 when it abandoned part of the self-regulation and adopted its present name.

Membership in the institute has never been required by the regulatory commissions as a condition of registration nor is the institute even referred to in any statute or regulations, so that the self-regulatory function has been quite unofficial. In fact, a substantial part of the mutual funds industry does not belong to the institute. Still, the institute prescribes a code of ethics dealing with overreaching, qualifications of salespeople, and insider transactions.

5. *Investment Dealers Association of Canada*

The Investment Dealers Association (IDA) has its head office in Toronto and maintains regional offices in Montréal and Vancouver and a district council in each of seven regions. Its self-regulatory activities take the form chiefly of a set of rules governing capital, insurance, qualification of employees, maintenance of records, and audits of its members. These rules generally parallel the rules of the stock exchanges. Because of overlapping membership, regulation of the total membership of the exchanges and the IDA is allocated among the self-regulatory organizations, so that for the most part a firm is subject to oversight by only one organization.

The association's membership includes the largest firms in the securities business and it may initiate fewer disciplinary actions than the other self-regulatory organizations. It is perhaps as much a trade association as a regulatory body.

The IDA is the organization with responsibility for most of the over-the-counter market in Canada. The Canadian money market operates under IDA rules, and volume in 1976 was $150 billion.[17] The over-the-counter market in stocks is small, and consists chiefly of secondary trading in new issues before the issues are listed. In 1976 this trading totalled $680 million and the rest of the over-the-counter trading in stocks amounted to only $113 million. Regulation consists chiefly of clearing rules and reporting of trades.

Market-makers and quote-makers in the Ontario over-the-counter stock market are designated by the IDA. The former are

17 The money market is discussed *infra*.

Table 18
Sources of Toronto Stock Exchange Member Firm Revenue by Type of Fi

As of years ending March 31, 1975–77

	All types		
	1975[a]	1976[a]	1977[a]
Equity agency income			
Toronto Stock Exchange	30.8%	30.7%	28.5%
Montreal Stock Exchange	8.2	7.4	6.6
Vancouver Stock Exchange	2.4	2.1	2.3
U.S. markets	6.2	7.8	5.8
Over-the-counter	2.8	1.8	1.4
	50.3	49.8	44.6
Underwriting	19.7	25.1	24.1
Trading			
Principal trading stocks	4.7	2.1	2.3
Principal trading bonds	7.9	10.4	14.1
Registered trading stocks	0.6	1.5	1.0
Money market	9.7	4.0	5.3
Other	7.2	7.1	8.6
	30.1	25.1	31.3
Total	100.0	100.0	100.0
Total income by class			

tional versified ms 77[b]	High value per trade (institutional) 1977[b]	Low value per trade (retail) 1977[b]
3.6%	56.7%	47.5%
4.9	22.8	4.1
1.5	0.7	11.7
5.9	5.6	6.6
1.2	1.8	3.6
7.2	87.5	73.5
3.5	0.5	5.6
2.7	0.4	0.2
5.8	4.1	7.6
0.3	4.5	4.9
6.3	—	0.1
9.2	3.0	8.1
4.3	12.0	20.9
0.0	100.0	100.0
3.0	9.0	8.0

a. Sample representing 78% of Toronto Stock Exchange trading in 1975, 72% in 1976 and 65% in 1977.
b. Sample representing 65% of Toronto Stock Exchange trading in 1977.
Source: Toronto Stock Exchange.

obliged to call "firm markets" – both a bid and an offer good for one round lot – in the stocks for which they make markets. A dealer is required to check with two market-makers before executing a client order and must execute the trade with a market-maker unless a better execution can be obtained elsewhere. A quote-maker simply undertakes a continuing interest in an issue.

All over-the-counter stock transactions in Ontario must be reported daily to the IBM Datacentre in Toronto and a report of all the trading goes to the IDA. Another report is published, showing volume, high and low for each security traded, but it includes only trades between Ontario dealers and other dealers, banks and trust companies.[18]

The over-the-counter market in bonds is much larger, since there is no listed bond market in Canada. Trading and clearing rules are established by the Montreal, Toronto and British Columbia bond traders associations. Statistics on bond trading are hard to find, and in April 1978 the Quebec Securities Commission announced a sampling of trading statistics to measure the breadth of the secondary bond market in Québec.[19]

C. ACTIVITIES OF SECURITIES FIRMS

The Securities Industry Ownership Committee of the Ontario Securities Commission discovered substantial changes in investment dealers' mix of business over the period from 1966 to 1971. Both brokerage and underwriting showed substantial swings in percent of gross income. The committee said: "it is not possible to reach any but the most general conclusions as to the needs for capital and the profitability of specific functions."[20] It appeared that only a few firms kept close enough track of costs to know how profitable the functions were.

Table 18 shows, for members of the TSE, the relative importance of different sources of revenue. Brokerage (equity agency income) accounted for just about half of this revenue in each of 1975, 1976 and 1977. Underwriting was significant, accounting for 20% to 25% of revenue. Dealing in stocks, bonds and money market instruments accounted for another 20%.

Table 18 also shows, for each of three types of TSE member, the importance of these sources for fiscal 1977. The national diversified firms show a much lower dependence on brokerage revenue than either the institutional or retail firms and a substantial

18 The rules and procedures were described in [1975] OSC Bull. 196 (August).

19 9 QSC Bull., No. 15 (Decision No. 5419, April 18, 1978).

20 OSC, Report of the Securities Industry Ownership Committee 64 (April 1972). The TSE now offers complete and detailed cost analyses to its members.

dependence on underwriting. Indeed, underwriting and money market trading together are as important as brokerage. And bond trading is also a significant activity.

For the institutional firms, brokerage accounted for nearly 90% of revenue. The retail firms were more diversified, with underwriting and bond trading accounting for about 13% of revenue and less than 75% of revenue was from brokerage.

What is more important, perhaps, than sources of revenue is sources of profit. The relative profitability of brokerage and of "other" business was explored by Calvin Potter in an Ontario Securities Commission staff position paper in 1977.[21] Potter concluded that for diversified firms, commission business was marginally unprofitable and other business was marginally profitable. For non-diversified firms, however, particularly institutional firms, the reverse was true. For the diversified firms, of course, the mutual dependence of commission and other business might well make commission business quite worthwhile. For the year ending in March 1977 it appears that commission business was unprofitable for diversified firms but profitable for institutional firms.

1. *Brokerage*

In Canada the stock brokerage function is essentially limited to trading on the stock exchanges and the brokers are all members of the exchanges. The economics of this particular activity and particularly the question of whether commission rates should remain fixed or become competitive are discussed in chapter III. The choice between dealer and broker markets and liability (dealer, as opposed to broker) trading on the exchanges is dealt with in Williamson, *Capital Markets* , in this volume.[22]

The debate over commission rates in 1976 and 1977 raised questions about concentration in the brokerage business and the potential for domination by a few firms. A fairly steady increase in concentration in trading on the Toronto Stock Exchange can be seen from table 19. The 48% of trading accounted for by the top ten firms in 1976 is higher than the corresponding 35% for the New York Stock Exchange.[23] The table was updated by the TSE in a submission to the Ontario Securities Commission; the top ten

21 *See* the discussion in ch. III *infra*.

22 *See, Williamson, Capital Markets*, ch. II, at text accompanying n. 48 and following.

23 The 35% figure comes from *Trends in Concentration in the Securities Industry*, published in Securities Industry Association, Securities Industry Trends 4 (August 29, 1977).

Table 19
Concentration in Trading on the Toronto Stock Exchange

1968–76
In millions of dollars

	10 top firms		25 top firms	
	Value of trading (both sides)	Percentage of total trading	Value of trading (both sides)	Percentage of total trading
1968	$3,751	38.4%	$7,831	67.9%
1969	4,415	38.5	6,728	66.5
1970	2,727	38.4	4,972	66.2
1971	3,788	40.4	6,343	67.6
1972	4,976	40.6	8,517	69.4
1973	5,804	43.4	9,608	72.0
1974	3,956	44.5	6,428	72.2
1975	3,663	45.3	6,005	74.3
1976[a]	2,410	48.1	3,886	77.5

a. Up to May 31, 1976.
Source: Toronto Stock Exchange, *Evolution of the Canadian Securities Market with Particular Focus on the Equity Market* 147 (June 1976).

Table 20
Canadian Securities Industry: Concentration in Commission Revenue and in Other Business Revenue

As of 12 months ending March 31, 1977

Commission revenue	
Top 5	37%
Top 10	55
Top 20	75
Top 25	81
Top 40	91
All 94	100
Other business revenue	
Top 5	64%
Top 10	86
Top 20	94
Top 25	96
Top 40	98
All 94	100

Source: Data on 94 firms, compiled by the Investment Dealers Association of Canada, and the Toronto and Montreal stock exchanges. *See* note 25 *supra*.

trading firms accounted for over 50% of trading value in the first four months of 1977.[24]

Table 20 shows the degree of concentration of commission revenue for approximately the twelve months ending March 31, 1977.[25] Comparison with table 19 suggests that the trend is up. But what is especially interesting is that concentration in "other revenue", which includes all revenue *except* commission revenue, is much higher. For the whole set of ninety-four firms, aggregate "other revenue" was also higher at $284 million than commission revenue of $212 million. (The ratio of commission revenue to total revenue, 43%, was very close to the corresponding ratio for the United States securities industry. As shown in table 18, the ratio for TSE members has been about 50%.)

For the top ten firms in terms of commission revenue, this revenue was $117 million and "other revenue" was $220 million. So for the firms that dominate the commission business, other revenue is almost twice commission revenue (just as we saw for national diversified firms in table 18), and these firms are even more dominant in other business. They had 55% of commission revenues and these same firms had 78% of other revenues.

These statistics suggest that although the focus of concern has been on concentration in commission business, concentration in other business is much more significant.

In the course of a study of commission rates in the securities industry a task force set up by the Quebec Securities Commission collected information on fifty members of the Montreal Stock Exchange, including the largest securities firms in Canada, and the statistics presented by the task force give some insights into the structure of the industry nationally. (Twenty-three of the firms were controlled in Québec, twenty-three were controlled in other provinces, and four were foreign controlled.)

The task force was able to draw some conclusions about concentration in the various activities of the securities business but since the sample was limited to fifty firms, and much of the analysis was concerned with the position of Québec-owned firms with respect to the rest of the industry, the conclusions are of limited value on a national scale. The analysis of profitability of

24 Toronto Stock Exchange, Submission to the Ontario Securities Commission regarding the Proposed Commission Rate Schedule, at 40 (May 16, 1977). U.S. concentration statistics are shown in table 39 in ch. III *infra*.

25 Data on the 94 firms are collected by the Investment Dealers Association and the Toronto and Montreal stock exchanges. Table 20 is based on data for the year ended March 31, 1977, for about half of the firms, for the year ended December 31, 1976, for about one third, and for years ended on dates between September 30, 1976 and August 31, 1977, for the remainder.

different lines of business was of wider interest but was limited to the year 1975.[26]

2. *Dealing*

The stock market in Canada is almost entirely a market in listed stocks, rather than an over-the-counter (OTC) market. There is a certain amount of dealing, or "liability trading", in listed stocks discussed in Williamson, *Capital Markets*,[27] but nothing like the United States OTC or third markets. Table 18 shows the almost negligible proportion of revenue derived by TSE members from OTC stock trading. Table 21 gives figures for OTC stock trading in Canada in 1976. The bulk of the trading was in new issues, after issuance but before listing on a stock exchange. Trading in genuine "unlisted" issues was very small – $113 million compared to stock exchange volume of nearly $7 billion.

Table 22 shows all the unlisted stocks for which OTC trading, apart from primary distribution, exceeded $500,000 in 1976. The list includes only seven industrial stocks, eight mines and one oil.

The Canadian bond market, on the other hand, is entirely a dealer market. We saw something of its relative importance in table 18. It accounted for 14% of the revenue of TSE members in 1977. Ten securities firms, according to Shaw and Archibald, participate "on a continuous basis, as market intermediaries in the secondary bond market".[28] Table 2 shows the aggregate bond inventory of securities dealers and table 21 gives an idea of the distribution of securities inventories.

Although the secondary bond market is substantial, volume and price information are not publicly disclosed apart from weekly bid and ask prices provided by the IDA, and annual statistics such as those in table 24. Reference has been made to a 1978 data collection in Québec.[29]

Table 24 shows aggregate trading in bond and money markets. The total volume of bond and money market trading in 1976 was about nineteen times the stock trading volume on the stock exchanges in Canada. The bulk of this trading was in money market instruments; bond trading volume alone was three and one-third times stock trading volume.

26 QUEBEC SECURITIES COMMISSION TASK FORCE, *supra* note 12. The conclusions on concentration are discussed *infra*, text accompanying note 170 and following.

27 *See, Williamson, Capital Markets*, ch. II.

28 D. SHAW & R. ARCHIBALD, 8 THE MANAGEMENT OF CHANGE IN THE CANADIAN SECURITIES INDUSTRY 51 (1977) (The Canadian Securities Market: A Framework and a Plan).

29 *See* 9 QSC Bull., No. 15 (Decision No. 5419 April 18, 1978).

Table 21
Canadian Securities Industry:
Concentration in Securities Inventories

As of March 31, 1977
In millions of dollars

	Securities inventory	
Top 5	$1,928	63%
Top 10	2,728	90
Top 20	3,009	99
All 94	3,046	100

Source: *See* note 25 *supra*.

able 22
ver-the-Counter Trading in Canadian Stocks

976
n thousands of dollars

	Total over-the-counter trading	Primary distribution	Trading in new issues, prior to listing	Trading in unlisted issues
ndustrials	655,800	2,341	569,362	84,097
Mines	64,113	10,039	29,173	24,901
Oils	85,884	997	81,251	3,636
Total	805,797	13,377	679,786	112,634

Source: Investment Dealers Association of Canada.

Table 23
Over-the-Counter Trading in Unlisted Canadian Stocks[a]

1976
In thousands of dollars

	Trading
Industrials	
AGF Special	687
Canadian Foremost Ltd.	763
London Life	28,903
Maritime Tel & Tel Co. Ltd.	3,529
Oxford Dev. Group Ltd.	1,062
Oxford Dev. Groups Ltd. Pfd.	42,015
Ready Foods	1,174
Mines	
Abino Gold Mines	953
Aggressive	774
Canuc Mines	7,438
Cavalier Energy	1,930
Dejove Mines	637
Gull Lake Iron Mines Ltd.	549
New Bedford	613
Reactor Ind.	882
Oils	
B.C. Oil Lands	3,153

a. Unlisted stocks for which trading, other than in primary distributions, exceeded $500,000.
Source: Investment Dealers Association of Canada.

Table 24
Money Market and Bond Trading in Canada

1976 and first half of 1977
In millions of dollars

	1976	First half of 1977
Money market trading		
Canada bills	14,355	14,377
Canada bonds due within 3 years	3,573	1,747
Provincial bills	3,732	1,206
Municipal bills	1,238	812
Canadian bankers acceptances	14,444	6,949
Canadian bank paper	20,028	10,977
Foreign bank subs paper due within one year	2,307	1,466
Corporate paper due within one year	28,616	13,065
Finance company paper due within one year	20,630	13,042
Total money market trading	108,923	63,641
Bond trading		
Canada bonds due in more than 3 years	8,339	6,453
Provincial bonds	7,130	3,979
Provincial savings bonds	41	2
Total provincial	7,171	3,981
Municipal bonds	589	522
Corporate paper due in 1–5 years	892	565
Corporate bonds	5,461	3,232
Total corporate	6,353	3,797
Other	833	446
Total bond trading	23,285	15,199
Total bond and money market trading	132,208	78,840

Source: Investment Dealers Association of Canada.

It does not seem possible with available data to make any estimates of the distribution of trading among securities firms or to assess the degree of concentration in trading.

3. *Underwriting*

Underwriting of mining and oil stocks of companies in the development stage is a very specialized business and is not described here.[30] For stock or bond offerings of established companies the underwriting process begins when a "managing underwriter" negotiates with the issuer the terms of the offering. The manager may then organize a "banking group" of underwriters, if the issue is large, and the offering will be sold by the issuer to the manager and by the manager to this group. Some members of the banking group will resell the securities to their institutional or retail customers. Some will allow the manager to sell at least a part of their allocations to members of a "selling group" for resale to their customers.[31]

In North America long-standing relationships between issuing corporations and managing underwriters are common, although there is a growing tendency for issuers to "shop around", and for underwriting firms to seek out issuers who may be willing to change underwriters. The same is true of relationships between governments and underwriters.

Statistics on underwriting participants are maintained by the Investment Dealers Association of Canada as well as by the major underwriting firms but there is a great reluctance to publish them. Shaw and Archibald reported in 1975 that sixty-nine securities firms had acted as managing underwriters for 795 corporate, provincial and municipal offerings in 1971 and 1972. Of the sixty-nine only two were classified as "major" underwriters in all three sectors, having managed at least ten issues in each. Four more were "major" underwriters in one of the three.[32] In 1977 they reported:

> "Four securities firms, operating nationally and internationally, dominate the primary market for Canadian is-

30 *See* J. Williamson at 295-99.

31 For more details, *see* J. Williamson at 282-92; Report of the Committee to Study the Requirements and Sources of Capital and the Implications on Non-Resident Capital for the Canadian Securities Industry 22-23 (May 1970) [hereinafter Moore Committee Report].

32 7 D. Shaw & R. Archibald, *supra* note 28, at 75-76 (The Securities Firm in the Canadian Capital Market).

sues and are active in all phases of the securities market as dealers and brokers."[33]

Shaw and Archibald do not identify any firms but these four would have to be A.E. Ames, Dominion Securities Harris & Partners, McLeod Young Weir, and Wood Gundy.

They go on to say:

"Eight securities firms have national and international operations and are extensively diversified across the market....

"These twelve securities firms (four diversified, dominant underwriters plus eight diversified) undertake a large proportion of the primary market activity for corporate and provincial government issues of commercial paper, long-term debt and equity. In addition, they dominate the secondary dealer market....

"Eight securities firms (the four diversified, dominant underwriters and four of the diversified firms) act as managing underwriters for a large share of the corporate and provincial securities offerings in Canada. These eight firms wield substantial power over the market intermediaries because they control the selection of firms for banking groups, inclusion in which is profitable."[34]

The eight diversified firms are probably Merrill Lynch Royal Securities, Nesbitt Thomson, Greenshields, Crang & Ostiguy (now merged with Greenshields), Pitfield Mackay Ross, Burns Fry, Richardson Securities of Canada, Walwyn Stodgell Cochran Murray. And the first four of these are probably the four referred to in the last paragraph in the quotation above – managing underwriters.

Some more recent statistics are presented in tables 25 and 26.[35] The fourteen firms listed (eleven by the end of 1973 as the result of mergers) were the top underwriters in 1974 and are ranked by volume of debt issue underwriting in 1974.

The two tables reinforce the suggestion in table 18 that the underwriting business is quite concentrated. This is not to say that the concentration is harming anyone, although there is certainly anecdotal evidence on the difficulty experienced by firms at-

33 8 D. Shaw & R. Archibald, *supra* note 28, at 45–46.

34 *Id.* at 46–47.

35 An offering made through more than one underwriter was attributed in full to each underwriter named in the filing. No attempt was made to allocate an offering among participating underwriters because the filings did not include enough information to make this possible.

Table 25
Underwriting in Canada: Corporate Equity Offerings[a]

1970–74
In thousands of dollars

	1970	1971	1972	1973	1974
Wood Gundy	7,005	136,907		68,503	248,786
A. E. Ames	937	110,450	10,112	16,891	176,526
Dominion Securities	4,046	115,259	41,882	51,000	201,526
Harris & Partners		6,900			
McLeod Young Weir		130,431	186,128	63,340	254,026
Greenshields		104,000	14,470	72,200	100,000
Pitfield Mackay Ross	5,520	14,602	33,770	9,606	
Nesbitt Thomson	6,680		167,450	6,961	146,526
Richardson Securities of Canada	20,320	12,525			156,526
Merrill Lynch					
Royal Securities	4,600	7,887	33,402	30,786	68,526
Lévesque Beaubien		59		3,250	100,402
Midland-Osler		6,900	126,456		
Doherty McQuaig			2,520	2,263	25,000

a. Offerings for which a prospectus was filed in Ontario, Québec or British Columbia. Figures shown are the values of total offerings in which the underwriters participated.
Source: Prospectus filings. *See* note 35 *supra*.

ble 26

derwriting in Canada: Corporate Debt Offerings[a]

'0–74

thousands of dollars

	1970	1971	1972	1973	1974
ood Gundy	882,000	782,250	677,000	545,000	887,500
E. Ames	568,000	401,000	484,000	265,000	730,000
minion Securities	235,500	346,000	400,000	175,000	545,000
rris & Partners	210,000	133,500	135,000	100,000	
Leod Young Weir	413,000	250,000	346,500	312,000	353,500
eenshields	120,000	205,000	88,000	20,000	221,500
field Mackay Ross	112,500	144,500	60,500	130,000	183,500
sbitt Thomson	454,500	217,500	155,000	295,500	175,000
hardson Securities of Canada	196,700	176,500	161,400	40,000	115,000
rrill Lynch	108,000	100,300	35,300	27,000	70,000
yal Securities					
vesque Beaubien	3,100	52,425	42,500	25,450	70,000
dland-Osler	233,000	56,000	35,000	175,000	30,000
herty McQuaig					

a. Offerings for which a prospectus was filed in Ontario, Québec or British Columbia. Figures shown are the values of total offerings in which the underwriters participated.

Source: Prospectus filings. *See* note 35 *supra*.

tempting to break into the business. But there may be legitimate reasons for this difficulty.[36]

The major Canadian underwriters show up well in a North American context. Table 27 shows underwriting volume for the top twenty-five underwriters in the United States market for the first half of 1977. McLeod Young Weir and Wood Gundy appear in the list covering all securities. They are joined by A.E. Ames and Dominion Securities in the list covering only negotiated (as opposed to competitive bid) offerings. A list of the top underwriters of foreign debt would include these four firms and Greenshields. A tabulation of top banks and investment banking firms in arranging private placements of securities in 1976 shows McLeod Young Weir in fourteenth place.[37] Their high rank, of course, reflects one or two major Canadian client relationships.

Underwriting appears to be a rather profitable activity in recent years (although precise measures are not available) particularly when compared to brokerage. So the firms not engaged in underwriting are especially interested in entering the field, while those already in have a reason for wanting to keep it to themselves. At the same time, one of the features of an increasingly competitive underwriting business in the United States is the expansion of brokerage activities by underwriting firms. This expansion is taking place not because brokerage itself is necessarily profitable but because the distribution facilities of a brokerage business are so important to successful underwriting. It is the enormous distribution ability of Merrill Lynch, for example, that is generally supposed to explain the firm's success in rapidly building a major underwriting business.

There seems to be evidence of competitive pressure from U.S. investment bankers for foreign underwriting of Canadian issues. A substantial amount of Canadian provincial, municipal, and industrial financing takes place in the United States and Europe and a good deal of the industrial financing is for Canadian subsidiaries of U.S. companies. According to Canadian dealers, the parent

36 See the discussion of the structure of the investment dealer industry in *Williamson, Capital Markets* at text accompanying n. 87; 8 D. Shaw & R. Archibald, *supra* note 28, at 47-49. The Securities Industry Ownership Committee of the Ontario Securities Commission reported for 71 Canadian-owned investment dealers responding to a questionnaire in 1971 that the 10 largest resident-owned firms accounted for 62.6% of total underwriting, and 65.2% of industrial underwriting. But these 10 largest had only 49% of total income; OSC Report of the Securities Industry Ownership Committee, *supra* note 20, at 54, 58, 157 and 159. More conclusions on concentration of underwriting are discussed in text accompanying note 170 *infra*. Underwriting appears to be much more concentrated than commission business.

37 *See* Angermueller & Taylor, *Commercial vs. Investment Bankers*, 55 Harv. Bus. Rev. 132 (September-October 1977).

companies sometimes direct the subsidiaries to make use of American dealers in offerings outside Canada.

There has been a good deal of concern in recent years about separation of brokerage from underwriting activities. In the United States there has been some litigation over the use of "inside information" gained from underwriting to assist brokerage clients.[38] As a result, there is usually a separation of the two functions within securities firms, very similar to the "wall" in U.S. banks that separates trust activities from commercial lending.[39] The same separation appears to take place in Canadian firms, although little is said about it.

This kind of conflict has come to the attention of the Council of the London Stock Exchange, which in June 1977 issued "notes of guidance" to member firms acting as brokers to listed companies. The notes called on member firms to effectively separate their corporate finance function from their other activities. The council said "the less definite this separation, the more difficult it will be for partners and employees of a firm to justify having dealt in, or having made a recommendation about, the securities of a company to which the firm acts as broker, if later called upon to do so".

The Toronto Stock Exchange established in 1968 a policy on fiduciary obligations of members as directors or fiduciaries of corporations,[40] which affirms an obligation not to reveal privileged information gained through the directorship or fiduciary relation. The policy goes further, and states that "the ground rules should be substantially the same" for a representative of a member "acting in an advisory capacity to a company and discussing confidential matters". National Policy No. 18 of the provincial securities commissions refers to the TSE policy and cautions representatives of registrants who serve as directors of public companies. But it says nothing about the use of information gained from an underwriting relationship. Section 125 of the Canada Business Corporations Act would impose liability on an underwriter who profited from inside information, but not necessarily on one who passed information to brokerage clients.

4. *Money Market Dealers*

The thirteen investment dealers that are also money market dealers make up a special class of securities firms. All of these firms

38 *See e.g.* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, 495 F.2d 228 (2d Cir. 1974).

39 Discussed in ch. IV *infra*.

40 Toronto Stock Exchange, Policies, pt. V, sec. 5.01, 3 CCH CAN. SEC. L. REP. ¶ 92-036. *See also, Connelly* at n. 127 and following.

Table 27
Underwriters of Offerings in the United States

First 6 months of 1977

Total securities: the top 25	Volume in thousands of dollars[a]	Number of issues
1 Morgan Stanley	$2,458,800	36
2 Merrill Lynch	1,920,100	86
3 Salomon Brothers	1,792,100	83
4 First Boston	1,595,500	64
5 Goldman Sachs	1,507,500	49
6 Blyth Eastman Dillon	1,299,200	46
7 Kidder Peabody	697,900	38
8 Lehman Brothers	643,700	30
9 White Weld	566,100	30
10 Bache Halsey Stuart Shields	548,300	37
11 Dillon Read	534,300	19
12 Dean Witter	525,500	31
13 E. F. Hutton	478,200	27
14 Kuhn Loeb	468,400	17
15 Paine Webber Jackson Curtis	387,100	28
16 Loeb Rhoades Hornblower	327,400	21
17 Smith Barney Harris Upham	323,100	27
18 Drexel Burnham Lambert	210,300	21
19 Warburg Paribas Becker	133,300	13
20 McLeod Young Weir[b]	133,300	3
21 Lazard Freres	133,300	6
22 Wood Gundy[b]	95,700	3
23 Shearson Hayden Stone	91,200	10
24 Wertheim	85,400	10
25 Reynolds Securities	67,100	6

Negotiated securities: the top 25	Volume in thousands of dollars[a]	Number of issues
1 Morgan Stanley	$2,072,000	23
2 Merrill Lynch	1,462,600	47
3 Goldman Sachs	1,309,500	35
4 First Boston	1,264,300	34
5 Salomon Brothers	1,161,200	36
6 Blyth Eastman Dillon	975,700	19
7 Lehman Brothers	457,400	15
8 Dillon Read	454,700	12
9 Kidder Peabody	411,100	16
10 Dean Witter	382,600	17
11 Kuhn Loeb	378,300	10
12 White Weld	343,600	10
13 E. F. Hutton	286,000	10
14 Bache Halsey Stuart Shields	261,200	10
15 Paine Webber Jackson Curtis	170,100	9
16 Smith Barney Harris Upham	159,500	11
17 Loeb Rhoades Hornblower	153,300	2
18 McLeod Young Weir[b]	133,300	3
19 Drexel Burnham Lambert	101,300	8
20 Lazard Freres	100,000	5
21 Wood Gundy[b]	95,700	3
22 Warburg Paribas Becker	89,900	6
23 A. E. Ames[b]	58,300	2
24 Nikko Securities	51,700	5
25 Dominion Securities[b]	45,700	3

a. Volume is calculated by allocating an offering equally among managers, with an extra share to the lead manager.
b. Canadian firms.
Source: *Institutional Investor*, September 1977.

have a line of credit with the Bank of Canada, and the bank, as a lender of last resort, will extend credit through securities purchase and resale agreements, buying from the dealers, who agree to repurchase. The rate charged is one-quarter of 1% above the average rate on three-month treasury bills, subject to a minimum of bank rate minus three-quarters of 1%. (The bank rate is the Bank of Canada rate charged to chartered banks.)

Equipped with the Bank of Canada credit facility, the money market dealers can borrow from chartered banks on day-to-day loans using as collateral Canadian government securities and bankers' acceptances.

During the first half of 1977 as much as $266 million of purchase and resale agreements was outstanding. The maximum of day-to-day loans outstanding was $342 million.

The thirteen money market dealers are:

A.E. Ames;
Burns Fry;
Dominion Securities;
Equitable Securities;
Midland Doherty;
Merrill Lynch Royal Securities;
McLeod Young Weir;
Nesbitt Thomson;
Pitfield Mackay Ross;
Richardson Securities of Canada;
Walwyn Stodgell Cochran Murray;
Wood Gundy;
Greenshields Crang Ostiguy.

The last has its head office in Montréal. The others are all Toronto-based. The two largest dealers are Wood Gundy and Dominion Securities, and they are said to control over 40% of the business.

There are apparently about 190 issuers of commercial paper in Canada. The largest, General Motors Acceptance Corporation of Canada, with about $700 million of paper outstanding, announced in the summer of 1977 that it would be placing paper directly with investors, thus bypassing the dealers.

About 75% of the dealers' business takes the form of purchases and sales as principal and 25% is agency business. Issuers ordinarily pay a commission for agency services and offer a discount to dealers buying as principals. Dealers are not allowed to pass on a part of the commission to investors (apparently as a result of IDA regulation) but they may set the price on a resale so as to pass on part of the discount. A principal business, however, requires capital.

The IDA through its Money Market Committee sets some

standards of conduct for money market dealing. There are margin requirements for dealer inventories and members may deal in corporate paper only if the issuer completes a Robert Morris Associates questionnaire or Canadian Sales and Finance (CANSAF) report (the paper is exempt from prospectus requirements).

5. *Money Management*

In February 1975 the Ontario Securities Commission announced it would hold hearings to determine whether registered dealers should be permitted to manage mutual funds. (There was no indication of concern about brokers or dealers exercising discretion over customer accounts.) The Toronto Stock Exchange and Investment Dealers Association filed a joint brief defending the management of funds by dealers. Only sixteen funds, with aggregate assets of $40 million (less than 2% of the mutual fund industry) were dealer-managed. The managers were twelve dealers, one of which did not offer fund shares in Ontario. The other eleven were all members of the IDA; ten were members of the TSE as well. The firms are identified in table 28 taken from appendix A of the brief. The funds were not members of the industry organization – then the Canadian Mutual Funds Association – and did not have "outside" directors.

After the hearings the OSC published Ontario Policy No. 3-32, which prohibits a dealer-managed fund from buying any securities from its manager, acting as principal, and from buying any securities underwritten by the manager within the preceding sixty days. There are no requirements for independent directors and no limits to trading. But the fund must disclose annually both the aggregate commissions and the management fees paid to the dealer-manager.

Although few securities firms are engaged in money management, Shaw and Archibald reported in 1975 that a move to money management was "the major change factor" mentioned by managers in retail firms.[41] This was seen as an important way to reach small investors at low cost.

In the late 1960s and early 1970s institutions in the United States, confronted with fixed, and it appeared to many of them excessive brokerage commission rates, began to press for direct access to stock exchanges. The New York exchange refused to admit financial institutions to membership either directly or

41 7 D. Shaw & R. Archibald, *supra* note 28, at 68. *See, Connelly*, at n. 163, on the general subject of brokers' discretionary management of funds.

Table 28
Registered Dealer-Managed Mutual Funds

1975
In thousands of dollars

	Funds	Net asset value
TSE/IDA members		
Bell Gouinlock	Enterprise Fund	130
Brault Guy O'Brien	Canagex Fund	13,800
	Canagex Bond Fund	4,800
	Canagex International	400
Hodgson	C. J. Hodgson & Co. Ltd. Investment Account	4,920
	Hodgson Pension Investment Account	259
	The Hodgson Retirement Savings Plan Fund	441
Housser	Educators Equity Fund	390
Jones Heward	Jones Heward Fund	2,130
Kingwest Securities	Harvard Growth Fund	2,312
	Pension Mutual Fund	1,560
	Xanadu Fund	1,861
Martens Ball Albrecht	Esto Mutual Fund	132
McEwen Easson	Canadian South African Gold Fund	4,083
Moss Lawson	Mosslaw Growth Fund	412
Walwyn Stodgell & Gairdner	Capital Growth Fund	980
	Capital Income Fund	1,131
		39,741
IDA member only		
Calvin Bullock	Acrofund	5,433
	Canadian Investment Fund	119,057
		164,231
TSE/IDA member[a]		
Pemberton Securities	Pacific Compound/Dividend Fund	5,997
	Pacific Income Fund	850
	Pacific Resource Fund	303
	Pacific Retirement Fund	1,669
	Pacific U.S. Fund	3,074
		11,893
Total		176,124

a. Funds not qualified for sale in Ontario.
Source: Appendix A of the brief submitted to OSC by the TSE and IDA, 1975.

through subsidiaries. But some of the regional exchanges accepted institutions and several joined.

The Securities and Exchange Commission (SEC) was confronted with arguments by member firms that institutions did not belong on exchanges because they were primarily money managers and arguments by institutions that many brokers were also money managers. It attempted to work out rules governing eligibility for membership. The rules called for an "80-20" split of brokerage: a member would have to do at least 80% of its brokerage for public customers and no more than 20% for itself or its affiliates.[42]

The "80-20" rule was one that most member firms could live with comfortably. But when the issue moved from the SEC to congressional hearings, the arguments by the exchanges and member firms against the iniquity of mixing brokerage with money management were more persuasive than they intended and the "80-20" rule became a "100-0" rule.

Blyth Eastman Dillon & Co. Incorporated was in 1972 the largest securities firm not a member of the New York Stock Exchange. The firm resigned its stock exchange membership in January 1970 when it became a wholly-owned subsidiary of INA Corporation. The sale to INA was, according to the president of Blyth, motivated by "a belief that it was necessary to make permanent the capital of people in our business, and private ownership did not assure the permanence of capital".[43] Blyth was quite willing to undertake to do no commission business with its parent and the president commented: "it seems only equitable,...that whatever regulation, in terms of the proportion of business that might be done between a broker-dealer and its parent, should be applied with equal effect to business done by the broker-dealer with what might be deemed to be institutional funds controlled by him."[44]

A representative of Connecticut General Life Insurance commented that in the competition between institutions and member firms for pension fund business the member firms had a competitive advantage in offering both brokerage and advisory services to potential pension fund clients. He said "we believe that it is the practice of these member firms to reduce advisory fees, either

42 Rule 19b-2 became effective in 1973. Floor traders were exempt from any limitations.

43 *Study of the Securities Industry: Hearings before the Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce*, 92d Cong. 2d Sess., pt. 8, at 3978 (April and May 1972).

44 *Id.* at 3979.

directly or indirectly, wholly or in part, by the amount of brokerage commissions paid by the managed account."[45]

The managing partner of Salomon Brothers, one of the most heavily capitalized investment banking firms in the U.S., said his firm did not oppose institutional membership for the purpose of entering the general securities business. He commented that widespread entry of insurance companies might pose questions of economic concentration but said: "non-financial institutions, however, could considerably strengthen the securities industry with permanent capital." With respect to brokerage and money management he said: "it would be unfair to permit member firms to manage mutual funds and other pooled investments while prohibiting institutional membership. Uniform standards should be applied to all firms regardless of whether they became brokers or money managers first."[46]

The summary of the principal provisions of the Securities Reform Act of 1975 for the Senate Committee on Banking, Housing and Urban Affairs commented that institutional memberships on stock exchanges had caused impediments to fair competition between investment managers, conflicts of interest, and distortions in the efficient allocation of securities trading. The act was to resolve these problems by prohibiting stock exchange members from effecting *any* transaction on the exchange for accounts in which the member or an associated person had a financial interest or with respect to which the member or associate exercised investment discretion.[47] Section 11(a)(1) of the amended Securities Exchange Act has this effect, subject to exceptions, including the authority of the SEC to make rules permitting transactions for a member's own account or "any other transaction".

The new legislation was not to affect existing members until May 1978, and the SEC began to draft new rules. In March 1977 three new rules were proposed to permit members to trade for their own accounts (yielding priority to nonmembers), to prohibit any transaction charges by member firms to accounts subject to their investment discretion, and to permit a member firm to use another firm for transactions in a managed account.[48]

The Securities Industry Association had difficulty adopting a

45 *Id.* at 3992.

46 *Id.* at 4031-32.

47 *Securities Acts Amendments of 1975: Hearings before Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 94th Cong., 1st Sess. 179 (February 19, 20 and 21, 1975).

48 Securities and Exchange Commission, Securities Exchange Act of 1934 Release No.

position on the separation of brokerage and portfolio management. It supported section 11(a) of the Securities Exchange Act, then asked SEC to relax the ban, then opposed the new rules and apparently prepared to press for repeal of section 11(a). Institutions, which had already achieved the benefits of competitive commission rates and did not feel the formerly strong need to join exchanges, were afraid the new rules might compel them to join to satisfy fiduciary obligations. And some members of Congress apparently felt the proposed rules contradicted section 11(a).

The SEC continued to struggle with the problem, while asking Congress to postpone the May 1978 effectiveness date for section 11(a). In March 1978 it modified the March 1977 proposal so as to (1) permit management of client accounts so long as the client's consent was obtained in advance of every trade, (2) permit management of accounts where transactions are handled by unaffiliated firms, (3) permit transactions for an associated person or a customer of an associated person if the same transaction for a client account would be permitted, and (4) permit members to trade for their own accounts in a variety of ways.[49]

6. *Diversification*

In 1976 a joint industry committee published a set of guidelines for diversification of the Canadian securities industry.[50] It was clear from the publication that the securities industry was uneasy over the growth of banks, trust companies and insurance companies and their diversification into securities-related activities. If developments in the United States were any guide, they suggested that banks in particular could provide stiff competition in the brokerage and underwriting business. The strategy of the joint industry committee seemed to be to draw defensible lines of demarcation between the securities industry and these threatening industries, to justify the demarcation and to restrain the securities industry itself so as not to undercut arguments for the restraint of competitors.

The securities industry in the United States had been undergoing substantial diversification, especially since the unfixing of commission rates in May 1975. There had been a substantial move away from dependence on a commission business, and the immi-

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13388, March 18, 1977, [1976-1977 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 81,013 (proposed rules 11a2-1, 11a1-3, 11a2-2).

49 SEC, Securities Exchange Act of 1934 Release No. 14563, March 14, 1978, 2 CCH Fed. Sec. L. Rep. ¶ 22,808.

50 Report of the Joint Industry Committee on Guidelines for Diversification of the Securities Industry (September 23, 1976).

nence of a National Market System with expected shifts in brokerage business and a very likely rise in dealer as opposed to broker activities has led to more diversification, some through mergers in 1976 and 1977.[51]

The joint committee began with the existing rules of the stock exchanges and the IDA. The by-laws of the Toronto Stock Exchange and Montreal Stock Exchange require that the principal business of a member "shall be that of a broker or dealer in securities and it shall be active in such business to an extent acceptable to the Exchange".[52] The by-laws of the Investment Dealers Association require that for a member "at least 60% of that portion of the total gross profits of the business which arises from its dealing with the public, or if the applicable District Council in its discretion so approves, at least 60% of the total dollar volume of the business, results from or consists of the underwriting, distribution or buying and selling from and to the public in Canada, and either as principal or agent, of investment securities".[53]

The committee divided present and potential activities of brokers and dealers into four general classes: securities-related activities; non-securities-related activities, but financial in nature; nonfinancial; and restricted industries (see table 29). It took the position that brokers and dealers should not enter the restricted industries, including banking, trust and loan business, and life insurance. It raised no objection to diversification into nonfinancial businesses so long as these were conducted through separate legal entities and did not jeopardize the financial strength of the broker or dealer operation. The committee was not explicit but by implication seemed to approve all of the securities-related activities and the financial activities. It was quite explicit in supporting dealer-managed mutual funds.

The Toronto Stock Exchange approved the committee's report in April 1977 and indicated that proposals to diversify should be submitted by members for exchange approval.[54]

While the joint industry committee's table of activities gives some idea of what brokers and dealers in Canada are doing, it provides no indication of the relative importance of these activities. Table 18 provides some insights into sources of revenue for TSE member firms.

51 Plans for a National Market System are discussed in *Williamson, Capital Markets*, ch. IV.

52 TSE by-laws, pt. V, sec. 5.01, 3 CCH CAN. SEC. L. REP. ¶ 89-271; MSE by-laws III, art. 3301, 3 CCH CAN. SEC. L. REP. ¶ 85-301.

53 IDA by-laws, No. 1, s. 1.1(b)(f), IDA, BLUE BOOK 404B (1977); IDA by-laws, No. 2, s. 2.2, *id.* at 406.

54 Toronto Stock Exchange, Notice to Members No. 1465 (April 27, 1977); Notice to Members No. 1538 (September 7, 1977).

Table 29
Present and Potential Activities of Securities Firms

Securities-related activities	
As agent	As principal
Stock trading*	Stock trading*
Bond trading*	Bond trading*
Corporate advisory services*	Underwriting*
Merger and acquisition advice*	Money market*
Execution functions*	Commodity trading*
Research*	Puts and calls*
Custodial services*	Mortgage banking*
Money market*	Federal funds trading*
Federal funds trading*	
Money management (discretionary accounts, investment counseling)*	
Mutual fund sales*	
Mutual fund management*	
Commodity trading*	
Options trading*	
Puts and calls*	
Mortgage brokerage*	
Venture capital*	
Leasing brokerage*	
Foreign exchange*	
Non-securities-related activities but financial in nature	
As agent	As principal
Interbank deposit brokerage*	Leasing as principals
Finance and loan activities	
Performance measurement*	
Income tax advice	
Estate planning	
Life insurance	
Real estate	
Fire, general and casualty insurance	
Non-financial	
This would include any non-financial business venture such as hotels, publishing, management consulting, computer services, etc.	
Restricted industries	
Operation of a bank licensed under the Bank Act.	
Operation of a trust or loan company licensed under the Trust Companies Act (Canada) or the Loan and Trust Corporations Act (Ontario) or other similar provincial legislation.	
Operation of a life insurance company licensed under the Canadian and British Insurance Companies Act (Canada) or similar legislation.	

*Areas where one or more firms are known to be active.
Source: *Report of Joint Industry Committee*, 1976, *supra* note 50.

Diversification clearly has implications for the capital needs of the industry. These needs are discussed later in this chapter. A case can be made that the Canadian securities industry is limited in terms of its present activities, let alone potential activities, because of its present capital and restricted access to further capital.

D. COMPETITION POLICY

1. *The Securities Industry and the Combines Investigation Act*

The Combines Investigation Act[55] prohibits, in general, conspiracies and agreements to limit competition, including agreements to share markets and agreements to maintain prices. Until the 1976 amendments, the statute applied only to the sale of products but in that year it was made to apply as well to the sale of services. So the fixing of minimum commission rates on stock exchanges and the usual practice, in international underwritings of securities of dividing markets (for example, giving the Canadian market to the Canadian underwriters and the United States market to the American underwriters) would appear to be illegal. However, the courts have interpreted the act to exempt conduct that is subject to regulation either by a government body or by certain self-regulatory organizations within an industry.[56] Since the Ontario Securities Commission has taken on the responsibility of direct review and approval of commission rates, it seems likely that the fixing of these rates would be regarded by the courts as exempt from the act. However, this is far from certain, and the Director of Investigation and Research under the act has said:

> "Those activities which are subject to regulation by a public authority, acting under valid and specific legislation are exempt, if the activity is effectively regulated and the regulation covers such matters and is for such purposes as to make the application of the Combines Act incongruous....
>
> "The fixing of minimum commission rates by the Toronto Stock Exchange is, in effect, an exercise of self-regulation by a cartel. (Furthermore, this action, in the absence of proper legislative or regulatory approval, would be in violation of the Combines Investigation Act.)
>
> "If this practice continues it is difficult to see how the

55 R.S.C. 1970, c. C-23, *as amended*.

56 In Reference re the Farm Products Marketing Act, 7 D.L.R. (2d) 257, [1957] S.C.R.

> [Ontario Securities] Commission can avoid detailed investigation, amounting to rate setting, to ensure that the public interest is being protected."[57]

The market splitting or price maintenance activities of securities underwriters in both primary and secondary distributions are specifically exempt from the act.[58] This exemption was added to the act at the request of the Investment Dealers Association when the act was extended in 1976 to apply to services.

Bill C-42, introduced in March 1977 (and again, with some revisions, in November 1977, as Bill C-13), would make a substantial change to the status of commission rate fixing and market sharing. First, the bill as originally presented, included no explicit exemption for underwriters or any other part of the securities industry. Second, it offered a specific exemption for "regulated activity" to replace the court interpretations referred to above.[59] The price fixing and market sharing prohibitions would not apply "in respect of regulated conduct" which was defined in terms of three requirements. First, the conduct would have to be expressly required or authorized by a public agency deriving its power from federal or provincial legislation and not appointed or elected by the persons to be regulated; the self-regulatory organizations then – the IDA or the stock exchanges – would not qualify as public agencies, while the Ontario Securities Commission would. Second, the public agency would have to be expressly empowered by legislation to regulate the conduct in the manner in which it was being regulated and the agency would have to have expressly directed its attention to the regulation of the conduct. Third, circumstances would have to be such that attainment of the regulatory objectives under the federal or provincial legislation would conflict seriously with the Combines Investigation Act. If all these conditions were met, then the act would not apply to the conduct. (The third requirement was eliminated by Bill C-13.)

The securities industry immediately objected to the proposals. Even though the Ontario Securities Commission had taken on responsibility for supervising and approving the fixed commission rates, there was considerable doubt that this activity complied with all of the elements described above as necessary to exempt the rate fixing from the act. In addition, nothing the Ontario

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198, the Supreme Court found regulatory schemes based on valid legislation not to be "to the detriment or against the interests of the public".

57 Submission by the Director of Investigation and Research, Combines Investigation Act, to the Ontario Securities Commission regarding Fixed Commission Rates on the Toronto Stock Exchange, July 1976, at 2, 13.

58 Section 4.1 exempts underwriting from ss. 32, 38.

59 In proposed new s. 4.5.

Securities Commission did would seem to confer an exemption on market sharing by underwriters. A variety of less significant regulatory activities by the stock exchanges and the IDA would also be suspect under the act. Finally, the IDA objected to prohibitions on interlocking directorships which might preclude an investment dealer from being a director of an underwriting client. The Combines Investigation Act does permit an arrangement that "relates only to a service and to standards of competence and integrity that are reasonably necessary for the protection of the public".[60] This clause might protect a number of the activities of a self-regulatory organization, but not all of them.

The IDA asked first for an exemption for the securities industry comparable to the exemption for underwriting in the present act.[61] Failing this, it asked for an exemption for the activities of a self-regulatory association if every member of the association were registered with a provincial or federal agency. For the securities industry this exemption would be equivalent to the first exemption requested. As a further alternative, it asked for a provision such that rules of the self-regulatory organization that were approved by a federal agency would be exempt. And as a final alternative, the IDA requested elimination of the explicit exemption for regulated conduct so that the case law would still stand. With respect to the specific prohibitions in Bill C-42 of market sharing in foreign distributions and interlocking directorships,[62] the IDA asked that at least the anticompetitive effects should be weighed against evidence of benefits.[63]

The Senate Banking, Trade and Commerce Committee reported in the summer of 1977 its general dissatisfaction with Bill C-42. Specifically, the committee recommended that industries and professions subject to regulatory agencies remain under the exclusive jurisdiction of those agencies.[64] It appears from the report of the committee that it approved the exclusion of self-regulatory organizations from the definition of a "public agency", but that it would have exempted from the proposed Competition Act *any* conduct authorized or tacitly approved by a public agency.

60 Section 32(G).

61 Submission by the Investment Dealers Association of Canada to the Hon. Anthony G. Abbott, Minister of Consumer and Corporate Affairs, May 17, 1977, at 6, 7, *reprinted in Minutes of Proceedings and Evidence of the Standing Committee on Finance, Trade and Economic Affairs*, issue No. 52, at 52A:36, 37 (June 7, 1977).

62 Sections 32.1, 31.75.

63 Submission by the IDA, *supra* note 61, at 9-10, 12-13, *reprinted in Minutes of Proceedings and Evidence of the Standing Committee on Finance, Trade and Economic Affairs, supra* note 61, at 52A:39-40, 42-43.

64 *Proceedings of the Standing Senate Committee on Banking, Trade and Commerce:*

The House Standing Committee on Finance, Trade and Economic Affairs, on the other hand, supported the proposition in the bill that even regulated conduct should be insulated from the free forces of the market only "where there is a clear and demonstrable public purpose to be served, and only then if adequate safeguards are put in place to insure that the public interest is adequately and fully taken into account by appointed bodies responsible for the supervision of those they regulate".[65] More specifically, the House committee supported the proposition that regulated conduct should be exempt from the proposed act, provided that it is being responsibly reviewed by an impartial body. And it expressed the opinion that an agency composed of representatives of the persons regulated is not impartial. But the committee felt that it would be enough to justify an exemption that the regulated conduct would be "required or authorized by a government appointed 'public agency' that is clearly entitled to control such conduct and is, in fact, attentively doing so".[66] The committee also recommended that the proposed Competition Board be given discretion to take into account any gains in efficiency to society.[67] Bill C-13 reflected this recommendation in its definition of restraint or injury as the result of market sharing or price fixing, and also provided an exemption for underwriters of international issues from the ban on market sharing.

2. *The United States Industry and Antitrust Law*

The SEC has had authority under the Securities Exchange Act of 1934 to veto as well as to modify or add to the rules and practices of a stock exchange. Over many decades, the power was exercised only once, in the so-called "multiple trading case".[68] The case arose in 1940, when the New York Stock Exchange issued a ruling barring its members from transactions on regional exchanges in interlisted stocks. The result of the ban would probably have been to put the regional exchanges out of business and to transfer all trading in interlisted stocks to the New York Stock Exchange. The commission instituted a public proceeding and issued an order rescinding the ban.

The application of the antitrust laws to the New York Stock

Fifth Proceeding on Study of the Subject Matter of Bill C-42 (Competition Policy), Interim Report, Issue No. 48, at 21-22 (July 6, 1977).

65 *Report of the Standing Committee on Finance, Trade and Economic Affairs, House of Commons Votes and Proceedings*, August 5, 1977, at 1467.

66 *Id.* at 1476-77.

67 *Id.* at 1519.

68 *In re* Rules of the N.Y. Stock Exchange, 10 SEC 270, 283-84 (1941).

Exchange was tested in *Silver v. New York Stock Exchange*[69] in 1963. The Court of Appeals for the Second Circuit reversed a judgment in favour of Silver, who complained of an exchange ban on private lines from his office to the offices of member firms, and held that the Securities Exchange Act of 1934 gave to the exchange powers in the exercise of which the exchange was not subject to the antitrust laws. The Supreme Court reversed, declaring that exemption from antitrust laws would apply only if necessary to make the Securities Exchange Act work and then only to the minimum extent necessary.

In 1967, however, the U.S. Supreme Court denied *certiorari* in *Kaplan v. Lehman Brothers.*[70] Kaplan had claimed that the fixing of minimum commission rates by the exchange's constitution was in violation of the antitrust laws but the District Court and Court of Appeals concluded that since commission rates were subject to review by the SEC, they were by implication exempt from the antitrust laws. This decision was in effect overruled in 1971, when the Supreme Court denied *certiorari* in *Thill Securities Corporation v. New York Stock Exchange.*[71] Once again, the case concerned fixed commission rates but the Court of Appeals held that SEC oversight did not necessarily imply antitrust immunity. Following *Silver*, anticompetitive conduct would be considered immune only if necessary for the operation of the Securities Exchange Act. Then in 1975, in the *Gordon* case, the Supreme Court unanimously found fixed commission rates on the New York exchange to be exempt from the antitrust laws.[72] The long history of fixed rates (since 1792), the congressional awareness of rate fixing and its delegation of fixed rate oversight to the SEC, and a conclusion that application of the antitrust laws to commission rate fixing would preclude and prevent the operation of the exchange act as intended by Congress, led to an implied immunity.

In June 1975 the Securities Reform Act of 1975 went into effect, just after the SEC had implemented its requirement that commission rates no longer be fixed. The revised Securities Exchange Act gives the SEC specific direction to remove existing burdens on competition and to prevent new burdens that are not necessary to the purposes of the act. The amendments removed

69 Silver v. New York Stock Exchange, 196 F. Supp. 209 (S.D.N.Y. 1961), *rev'd*, 302 F.2d 714 (2d Cir. 1962), *rev'd and remanded*, 373 U.S. 341 (1963).

70 Kaplan v. Lehman Brothers, 250 F. Supp. 562 (N.D. Ill. 1966), *aff'd*, 371 F.2d 409 (7th Cir. 1967), *cert. denied*, 389 U.S. 954 (1967).

71 Thill Securities v. New York Stock Exchange, 433 F.2d 264 (7th Cir. 1970), *cert. denied*, 401 U.S. 994 (1971).

72 Gordon v. New York Stock Exchange, 422 U.S. 659 (1975). *See* Linden, *A Reconciliation of Antitrust Law with Securities Regulation: The Judicial Approach*, 45 GEO. WASH. L. REV. 179 (1977).

section 15A(n) which had stated that section 15A, concerning registered securities associations, should prevail over all other legislation. The Senate committee report declared that this removal was not intended to change the state of the law[73] and it appears that Congress wished to perpetuate the conclusions in the *Silver* and *Thill* cases, to the effect that behaviour necessary to the purposes and operation of the act but no other behaviour would be exempt from the antitrust laws. The *Gordon* case, however, may have frustrated this wish.

E. SOURCES AND ADEQUACY OF CAPITAL IN THE CANADIAN SECURITIES INDUSTRY

When the giant of the United States securities industry – Merrill Lynch, Pierce, Fenner & Smith – purchased Royal Securities in 1969, the Investment Dealers Association and the major stock exchanges promptly established a committee to study sources of capital for the industry and agreed to accept no applications for nonresident capital participation in member firms pending the committee's report. The industry was caught between the threat of an invasion by well-capitalized foreign firms (Merrill Lynch already had far more capital than the entire Canadian industry and the New York Stock Exchange was about to authorize public ownership of member firms)[74] and a policy agreed to by the industry and apparently by the Ontario Securities Commission that sources of outside capital for securities firms be limited to the resources of those engaged in management.

The committee published its report in May 1970 and recom-

73 Securities Acts Amendments of 1975, Report of the Committee on Banking, Housing and Urban Affairs, to Accompany S. 249, S. Rep. No. 75, 94th Cong., 1st Sess. (April 14, 1975).

74 The New York Stock Exchange, under extreme pressure from Donaldson, Lufkin and Jenrette, which had announced that it was "going public" and would leave the exchange if necessary, agreed to public ownership of members in July 1970. NASD firms had for some years been allowed to have public shareholders. Merrill Lynch began operating in Canada in 1925, through an office of one of its predecessors, E.A. Pierce & Co. (a U.S. firm founded in 1820), in Toronto. Offices were subsequently opened in Montréal, Vancouver and Calgary in 1960, 1964 and 1968. Merrill Lynch joined the Investment Dealers Association of Canada in 1952, took over the E.A. Pierce seat on the TSE in 1940, and joined the Montreal and Vancouver exchanges when offices were opened in those cities. In 1969 Merrill Lynch acquired 100% ownership of Royal Securities, a firm with 15 offices located in all the provinces. The Merrill Lynch Canadian operations were subsequently merged with Royal Securities, to form Merrill Lynch, Royal Securities Limited. Merrill Lynch (U.S.) became publicly owned in June 1971; Submission by Merrill Lynch, Pierce, Fenner & Smith Incorporated and Royal Securities Limited to the Ontario Securities Commission Industry Ownership Study Committee, at 2, 3, 16 (September 1971).

mended very limited recourse by securities firms to capital outside management resources and maximum 25% ownership of a Canadian firm by non-resident individuals (but not foreign securities firms), with a grandfather clause to protect existing foreign-owned firms, provided they and their parents did not make use of capital sources forbidden to resident-owned firms.[75]

The committee concluded that the industry's capital was adequate. Brokerage was found to be the activity needing the greatest amount of capital. Dealer activities required less (114 firms used 25% of their capital for this purpose). The capital of 102 firms furnishing data had grown at 7.5% a year in the decade 1959 to 1969, mostly from retained earnings, and the committee concluded that this growth had been sufficient to meet the demands placed on the industry.[76] It went on to say that over the medium term it appeared that current sources of capital would be adequate.[77] However, the committee did recognize a "turnover" problem involving transfer of ownership from older management to younger succession while maintaining firm capital and concluded that a certain amount of outside financing might be appropriate to deal with it.

After reviewing the disadvantage of "outsider" investment in securities firms, including influences that might detract from good faith dealing and possible restrictions on competition, and conflicts inherent in a firm selling and dealing in its own securities, the committee recommended limited recourse to "approved investors" outside the firm. These investors would require approval of the firm's board of directors and by the appropriate "regulatory authorities", the Investment Dealers Association or a stock exchange. Approved investors would be limited to 50% of the capital of a firm and subordinated debt held by them would have to be medium- or long-term debt. No more than 25% of a firm's

75 Moore Committee Report, *supra* note 31, at 10-14, 17-18. A joint industry committee disagreed with the Moore Committee Report on two points: it recommended "Canadianizing" the existing nonresident-controlled firms and it recommended that nonresident securities firms be allowed to hold all or part of the 25% nonresident ownership, with any one firm's holdings limited to 10%; Report of the Joint Industry Committee on the Moore Report (July 1971).

76 Moore Committee Report, *supra* note 31, at 53.

77 *Id.* at 55. Merrill Lynch challenged this conclusion, and suggested probable growth in dealer activity in Canadian stocks; *see* Merrill Lynch submission, *supra* note 74, at 22-23. It was not until 1977, however, that a substantial change in the scope of this activity came about. *See, Williamson, Capital Markets*, ch. II. Merrill Lynch noted that when Goodbody & Co., one of the largest U.S. brokerage firms, failed in 1970, Merrill Lynch was the only firm sufficiently capitalized to take it over; Merrill Lynch submission, *supra* note 74, at 25.

voting or participating (in profits) securities could be held by outsiders and no one outsider could hold over 10%.[78]

It is interesting that the committee recognized that the restrictions it proposed for members of the IDA and the stock exchanges would put these firms at a serious disadvantage with respect to nonmembers, unless the latter were bound by the same restrictions. It is hard to see in this conclusion anything other than a realization that the restrictions would reduce the ability of firms to serve customers efficiently. The committee's report urged the IDA and the stock exchanges to press for government action to impose the restrictions on nonmembers too.[79]

Shortly after the Moore Committee released its report, a committee appointed by the Québec Minister of Financial Institutions, Companies and Cooperatives to consider the same issues published its interim and final reports. The conclusions of the Bouchard Committee differed dramatically from those of the Ontario industry committee. One reason had to do with the ownership of the Québec securities industry. While firms controlled in Québec made up 60% of the number of firms included in a survey of the industry, over 60% of the Québec industry's capital was represented by Ontario-based firms.[80] Some other statistics, including share of total inventories of securities, showed an even clearer domination of the industry by Ontario firms. Of the top fifteen firms, in terms of capital, ten were Ontario firms and only three had head offices in Québec.[81] And it was clear that Ontario firms showed a much greater penetration of the Québec securities market than Québec firms had achieved in the Ontario market. [82]

The Bouchard Committee was also impressed with the importance of capital to a securities firm, concluding that there were important economies of scale. The report went so far as to recommend a minimum total capital of $250,000.[83]

Given this background it is not surprising that the *Bouchard Report* recommended that no purchase or sale of securities by

78 Moore Committee Report, *supra* note 31, at 100-04, 115-19. The recommendations, as modified by a Joint Industry Committee, are summarized in OSC, Report of the Securities Industry Ownership Committee, *supra* note 20, at 141-43.

79 Moore Committee Report, *supra* note 31, at 115. The Joint Industry Committee agreed with the *Moore Committee Report* recommendations as a temporary device, but said that the restrictions on outside capital would place the Canadian securities industry at a disadvantage with respect to the industry in the United States; Report of the Joint Industry Committee, *supra* note 75.

80 Québec Department of Financial Institutions, Companies and Cooperatives, 1 Study on the Securities Industry in Québec, Final Report 38 (June 1972) [hereinafter Bouchard Report].

81 *Id.* at 82.

82 *Id.* at 86.

83 *Id.* at 115.

Québec investors be allowed except through an agent registered with the Quebec Securities Commission[84] and that firms registered with the commission be free to sell up to 49% of their voting capital stock to outsiders.[85] But ownership by a single outsider would be limited to 10% of the voting capital in a firm[86] and at least 25% of the voting stock of any firm operating in Québec would have to be owned by officers and employees resident in that province.[87]

The *Interim Report* of the Bouchard Committee had been published when the Securities Industry Ownership Committee of the Ontario Securities Commission was charged with a study of capital and foreign ownership in the Ontario industry. The Ontario committee was impressed with the difficulties in passing ownership of a securities firm from retiring to new management and at the same time maintaining the firm's capital.[88] The Moore Committee had admitted the problem was a real one but the Securities Industry Ownership Committee followed it up to discover the substantial increase in subordinated loans that, with share capital and surplus, make up the bulk of the capital of the firms. From 1964 to 1971 for 71 investment dealers, subordinated loans rose from 15% to 31% of the sum of share capital and loans.[89] At the same time surplus was probably rising substantially so that loans as a fraction of total capital may have been rising much more slowly. The ratio in 1971 was 16%.[90] For five Canadian-owned brokers (members of the TSE but not the IDA), however, subordinated loans were 37% of total capital in 1971.[91] As a practical matter subordinated loans are for most firms probably the most flexible ownership device. Capital can be inserted and withdrawn quickly and easily, which is convenient for the owners but means that a portion of the industry's capital is subject to rapid withdrawal.

The committee could not find much evidence upon which to base conclusions on capital adequacy. Not only did the "mix" of business show substantial changes over the years but few firms seemed to know how profitable their different activities were.[92] There was a little evidence of business turned away for want of

84 *Id.* at 128. The intention was that Québec investors be required to use Québec brokers and not go to markets outside the province; *see* discussion in note 13 *supra*.

85 Bouchard Report, *supra* note 80, at 130.

86 *Id.* at 132.

87 *Id.* at 134.

88 OSC, Report of the Securities Industry Ownership Committee, *supra* note 20, at 50-51.

89 *Id.* at 157.

90 *Id.* at 156.

91 *Id.* at 161.

92 *Id.* at 64-65.

capital[93] and the committee concluded that additional and more permanent capital was needed by the securities industry if it was to achieve greater efficiency, provide broader advice and more effective service, particularly to attract institutional clients, and if it was to remain competitive in the national and international securities markets.[94]

In considering sources of capital the committee rejected continuation of the existing policy of the commission which was to limit capital to the resources of those managing the firm.[95] It also rejected the Moore Committee's recommended limited use of outside capital from "approved investors" but did not go quite as far as the Bouchard Committee had gone in its *Interim Report* in proposing more or less unlimited access to investor capital. The committee recommended access to outside capital subject to a set of conditions very similar to those of the NYSE and NASD in the United States. A dealer might offer its securities to the public if it were a public company with at least $2 million in equity capital, of which at least $1 million would have to be issued shares, and half of them voting shares. Some criteria having to do with experience and stability would have to be met and any holder of 5% or more of a class of transferable securities, other than an officer or director, would have to be "approved" by the commission.[96]

Table 30 shows the top twenty U.S. securities firms by size of capital, and the capital (equity plus subordinated debt) of ninety-four Canadian firms and sets of these firms.[97] It is clear that capital in the Canadian industry is very small by U.S. standards. The top twenty U.S. firms had capital of $2,503 billion, twelve and a half times the capital of the Canadian industry. The entire United States industry probably had twenty times the capital of the Canadian industry. Even if Merrill Lynch is excluded, the nineteen largest U.S. firms in table 30 had over nine times the capital of the entire Canadian industry. This contrasts sharply with the respectable showing of Canadian firms in lists of top underwriters in the United States.

About a dozen Canadian investment dealers file annual financial statements with the Corporations Branch of Consumer and Corporate Affairs Canada, in Ottawa. Wood Gundy is one of them and almost certainly has the largest capital of any Canadian firm;

93 *Id.* at 66.

94 *Id.* at 77. The committee was also impressed with the criticisms in the "informal" *Gray Report*, leaked to the press in mid-November 1971, of the capital market in Canada.

95 *Id.* at 80.

96 *Id.* at 95-96, 183-87.

97 *See* note 25 *supra*, for details on data source.

Table 30
Capitalization of the United States Securities Industry, Ranked by Group and Size of Firm, with Comparative Canadian Data

As of March 31, 1977
In thousands of dollars

U.S. firms		Capital[a]	Canadian firms
1	Merrill Lynch	640,000	
		200,000	All 94
		192,000	60 largest
2	Salomon Brothers	192,000	
		180,000	40 largest
3	Dean Witter Reynolds	176,000	
		157,000	20 largest
4	Bache Halsey Stuart Shields	152,000	
5	E. F. Hutton	150,000	
	11 major U.S. regional firms	130,000	
		123,000	10 largest
6[b]	Paine Webber Jackson & Curtis	116,000	
7	Goldman Sachs	100,000	
8[b]	Loeb Rhoades	88,796	
9	First Boston	85,912	
10	Blyth Eastman Dillon	85,527	
11[b]	Shearson Hayden Stone	84,112	
12	Stephens	83,831	
		78,000	5 largest
13[b]	Drexel Burnham Lambert	75,000	
14	Donaldson Lufkin & Jenrette	74,000	
15	White Weld	73,000	
16	Allen	70,605	
17	Kidder Peabody	65,068	
18	Smith Barney Harris Upham	65,068	
19	Becker Warburg Paribas	65,000	
20[b]	Lehman Brothers	58,781	

a. Capital includes equity and subordinated debt.
b. Subsequently grown through merger.
Sources: United States data, *Securities Week* (New York), October 17, 1977; Canadian data, *see* note 25 *supra*.

as of December 31, 1976, its capital (equity and subordinated debentures) was about $24 million. This size would have placed Wood Gundy about thirty-seventh in a ranking of U.S. firms. (Wertheim & Co., Inc., with a capital of $24.6 million, ranked thirty-seventh at the end of 1976.) It would come after the major national underwriters, but it would come ahead of the major U.S. regional firms. Piper, Jaffray & Hopwood Incorporated had a capital of $16.5 million, Dain, Kalman & Quail, Inc. had $15.5 million, and Prescott, Ball & Turben had $14.6 million.

The degree of concentration of capital in the Canadian industry (see table 31) is about the same as for commission revenue (as shown in table 20) and is greater than concentration in the United States, where the top twenty-five firms have about 64% of industry capital. The correlation between capital and commission revenue, as shown in table 32, seems to be fairly high, at least for the largest commission firms. These firms, ranked on the basis of commission business, show about the same share of both industry capital and commission revenue.

The correlation between capital and "other revenue" shown in table 33, seems to be somewhat lower for the top "other revenue" firms. A regression analysis for all ninety-four firms showed:

Capital = $470,000 + $.30 per $1 of commission revenue + $.33 per $1 of other revenue.

And:

Capital = $440,000 + $.32 per $1 of total revenue.

These results can be compared with the figures in table 34 which represent the judgment of TSE members on the capital needed for commission business and other business. The membership collectively estimated about 40¢ in capital to support $1 in annual commission income, while the regression above indicated 30¢. But the regression also indicated a "basic" capital of close to $500,000 for a member firm, so the difference is not surprising. The membership estimated about 50¢ of capital to support $1 of total income, while the regression indicated 32¢. Once again, the difference is not surprising, because the regression includes $440,000 of basic minimum capital. Both the membership estimates and the regressions indicate that less capital is required to support a dollar of commission revenue than to support a dollar of "other" revenue.

F. FOREIGN OWNERSHIP

1. *The Canadian Securities Industry*

The *Moore Committee Report* listed fifteen securities firms either controlled or wholly-owned abroad with memberships in

Table 31
Canadian Securities Industry: Concentration in Capital

1976–77

	Capital
Top 5	39%
Top 10	61
Top 20	78
Top 25	82
Top 40	90
All 94	100

Source: *See* note 25 *supra*.

Table 32
Canadian Securities Industry: Concentration in Commission Revenue and Corresponding Capital

1976–77

	Commission revenue	Capital
Top 10	55%	58%
Top 20	75	75
Top 40	91	84
Top 60	98	89
All 94	100	100

Source: *See* note 25 *supra*.

Table 33
Canadian Securities Industry: Concentration in Other Revenue and Corresponding Capital

1976–77

	Other revenue	Capital
Top 10	86%	57%
Top 20	94	72
Top 40	98	83
All 94	100	100

Source: *See* note 25 *supra*.

ble 34
pital Allocation of Toronto Stock Exchange Member Firms

76 and 1977
dollars

	Capital used for agency business[a]		Capital per $100 total income[b]		Capital per $100 security agency income[b]	
	1976	1977	1976	1977	1976	1977
l classes	36.1%	34.1%	$52.3	$49.3	$40.4	$38.7
ational diversified ms	30.0	27.2	53.2	49.0	37.9	35.9
gh value per trade stitutional)	70.5	70.5	46.0	45.4	40.4	36.6
w value per trade tail)	66.9	71.4	52.5	56.1	55.8	56.1

a. As of March 31.
b. Years ending March 31. Some differences in 1976 and 1977 samples of firms.
Source: Toronto Stock Exchange.

one or more of the IDA and the four stock exchanges. Of the fifteen, thirteen were controlled by or were branches of U.S. firms. The brokerage activities of these firms were chiefly in U.S. securities,[98] and they had not been very active in underwritings in Canada until the Merrill Lynch acquisition of Royal Securities suggested a change.[99] (It is not clear from the report whether Canadian underwriting would be a credit to the foreign-controlled firms or would be held against them. This lack of clarity may stem from a belief that if they were active in underwriting they would benefit Canadian industry but would present unwelcome competition to Canadian underwriting firms.)

After lengthy consideration of possible costs and benefits associated with foreign (essentially U.S.) controlled firms operating in Canada, the report concluded that no more such firms should be allowed to join the IDA or the stock exchanges and that no investment by a foreign securities firm should be permitted in any member, but that a grandfather clause should protect existing foreign-controlled members.[100] But even that protection would be precarious, with membership subject to withdrawal of the grandfather clause if control of the firm were transferred or capital were obtained in a manner not open to Canadian-controlled firms.[101]

Again, the fear of the competitive advantages that would accrue to firms able to raise capital from the public led the committee to urge that a foreign firm be denied registration if it obtained

98 For the fiscal year ending March 31, 1969, commissions on transactions in Canadian securities for Canadian residents for the group were given as $10 million, and commissions on transactions in U.S. securities for Canadian residents as $17 million; Moore Committee Report, *supra* note 31, at 126. Merrill Lynch, however, said that on July 31, 1971, it held $56.5 million in Canadian securities and only $13 million in U.S. securities for Canadian customers. For all of its customers it was holding $265 million in Canadian securities; Merrill Lynch submission, *supra* note 74, at 9, 39. Merrill Lynch also commented on the recent admission of two Canadian firms by the New York Stock Exchange. The *Moore Committee Report* had noted that 15 Canadian firms had offices in the U.S.; Merrill Lynch submission, *supra* note 74, at 47.

99 Moore Committee Report, *supra* note 31, at 127. Merrill Lynch said frankly that "[it] had in prior years been advised on a number of occasions, privately, that neither Merrill Lynch nor any other American brokerage firm would be invited to participate generally in syndicate or banking groups in Canada"; Merrill Lynch submission, *supra* note 74, at 11. Entry into underwriting in Canada (Merrill Lynch was already underwriting Canadian issues in the U.S.) was a principal objective of the acquisition. Corporate and government securities underwriting by Royal Securities increased substantially after the Merrill Lynch takeover; Merrill Lynch submission, *supra* note 74, at 15.

100 Moore Committee Report, *supra* note 31, at 139-40. The different view of the joint industry committee was noted in note 75 *supra*.

101 Moore Committee Report, *supra* note 31, at 143.

capital in a manner different from those permitted to Canadian firms, especially from a public distribution of securities.[102]

The Bouchard Committee took a very different view. While Ontario firms overshadowed Québec-based firms, the report was able to say:

> "[W]e examine non-Canadian firms and find that their share of the market is negligible. There is no danger therefore at the present time of domination of the Canadian market by non-Canadian firms.[103]

And no limitation was proposed for foreign firms beyond the general ownership rules set out above.

A perhaps surprising recommendation was that membership in the MSE or the IDA should be a condition for registration of a firm with the Quebec Securities Commission, given the clear indication that nonresidents would be barred from membership.[104]

In 1971 the Province of Ontario provided by regulation that nonresident ownership of new registrants with the Ontario Securities Commission would be limited to 25% with no single nonresident or associated group of nonresidents holding more than 10%.[105] At that time there were thirty-eight securities firms registered in Ontario that did not comply but were protected by a "grandfather" clause. Of these, eight firms were members of the TSE and IDA, one was a member of the TSE, and three were members of the IDA. The balance were chiefly investment counsellors and mutual fund dealers. Virtually all were subsidiaries of U.S. firms.[106]

The IDA and the TSE had already declared a moratorium on accepting new nonresident-owned members while the Moore Committee was studying the subject and, as we have seen, the Moore Committee came out against foreign-owned firms in the Canadian industry.

The Securities Industry Ownership Committee of the Ontario Securities Commission referred to the regulation as a stopgap, to prevent foreign firms from exploiting the undercapitalized Canadian industry until the resident-owned firms could obtain access

102 *Id.* at 146.

103 Bouchard Report, *supra* note 80, at 82.

104 *Id.* at 125.

105 OSC, Report of the Securities Industry Ownership Committee, *supra* note 20, at 97-98. The Regulation, O. Reg. 296/71, was amended in 1974 twice, by O. Reg. 95/74 and O. Reg. 600/74. The amendments can be found in [1974] OSC Bull. 26 (March), and [1974] OSC Bull. 151 (August). The second amendments brought about what proved to be a critical set of standards governing transfer of ownership or control of a nonresident-owned firm.

106 OSC, Report of the Securities Industry Ownership Committee, *supra* note 20, at 101, 153-54.

to new capital. At that stage, the domestically-owned firms would presumably not need further protection and the issue of foreign influence would have to be resolved at the federal level.[107]

At the same time, the policy in Québec was to register at least some nonresident-owned firms. The *Bouchard Report* had recommended this,[108] and Québec had registered wholly-owned subsidiaries of two U.S. firms after the Ontario government announced its restrictive regulations.[109]

The Ontario committee concluded that the 25%/10% maximum nonresident ownership limits referred to above should apply to nonvoting shares and debt securities as well as to voting shares.[110] It disagreed with the Bouchard conclusion that foreign-owned firms contribute to the Québec economy saying that these firms (at least in Ontario) chiefly facilitate investment by Canadians in foreign securities, and the removal of capital from Canada.[111] However, recognizing that some foreign-owned firms may be beneficial, the committee recommended giving the commission power to relax the 10% rule. Existing foreign-owned firms would be allowed to continue subject to commission approval of any change in ownership and to limitations on growth.[112]

The Securities Industry Ownership Committee saw a "back door" to the Canadian securities market left open by the "exempt purchaser" provision of the Ontario Securities Act[113] and commented with some dismay that:

> "the exemption permits non-registrants to trade without the necessity of Ontario registration with sophisticated classes of the investment public – including banks, loan and trust companies, insurance companies, and 'recognized' exempt purchasers. The exemption was created long before the institutional investor became such a powerful force in the marketplace."[114]

The committee objected strongly to the offering of U.S. securities to Canadian institutions by U.S. dealers not registered in Ontario and said:

> "We view it important that Ontario registrants be used

107 *Id.* at 99.

108 *See* text accompanying note 103, *supra*.

109 OSC, Report of the Securities Industry Ownership Committee, *supra* note 20, at 100.

110 *Id.* at 101.

111 *Id.* at 111-12.

112 *Id.* at 114-16.

113 Section 190(3) of the Ontario Securities Act exempts from registration trades where the purchaser is recognized by the Ontario Securities Commission as an "exempt purchaser".

114 OSC, Report of the Securities Industry Ownership Committee, *supra* note 20, at 46.

by Ontario money managers whether the ultimate decision be to trade in United States or other foreign securities or not."[115]

There have been four significant decisions by the Ontario Securities Commission on applications by nonresident-owned firms for approval of a change in ownership. The first involved Laidlaw Securities Canada Limited and was decided before the 1974 amendments to the Ontario regulations referred to above. Laidlaw Securities was owned by a U.S. firm, Laidlaw Inc., and asked approval of a transfer of ownership to another U.S. firm, Laidlaw Capital Services, Inc. Laidlaw Securities had been American-owned since 1901 and was a member of the IDA and the Montreal and Toronto stock exchanges. The commission found the transfer not to be prejudicial to the public interest and approved it.[116]

The second case involved DuPont Glore Forgan Canada Limited which had become American-owned in 1951; the application was for approval of a sale by the financially troubled U.S. parent, DuPont Glore Forgan Incorporated, to the U.S. firm, Paine Webber Jackson & Curtis Incorporated. The new regulations which were to be announced a couple of months later required a finding before the commission could give its approval that without the approval a unique and beneficial service to Ontario investors would be lost. Without referring to any amendments to the regulations, the Ontario commission applied this standard (implying that it had done the same in the *Laidlaw* case) and rejected the application.[117]

The third case concerned Baker Weeks of Canada Ltd. This firm was a wholly-owned subsidiary of the U.S. firm, Baker Weeks & Co. Inc., which had acquired it in 1955. In 1976, the firm applied to the Ontario Securities Commission for approval of a change in ownership from Baker Weeks & Co. Inc. to Reynolds Securities Inc., another U.S. firm that was absorbing all the assets of the American Baker Weeks.

Baker Weeks of Canada Ltd. was a member of the IDA and both the Toronto and Montreal stock exchanges. The IDA and the Toronto exchange opposed the application but presented no evidence to the commission. The commission interpreted the regulations as permitting it to approve a change in control where it was satisfied that the nonresident-controlled registrant provided ma-

115 *Id.* at 47. *See also id.* at 109–11.

116 *In re* regulation 6a to the Securities Act and Laidlaw Securities Canada Limited, [1973] OSC Bull. 100 (July).

117 *In re* the Securities Act and DuPont Glore Forgan Canada Limited, [1974] OSC Bull. 133 (June).

terial or unique services to Ontario investors not substantially available through other registrants and that continuation of the service was dependent upon continued nonresident control and not against the public interest.[118] Apparently the fact that Reynolds was publicly owned induced the Toronto Stock Exchange to protest strongly but the commission gave its approval subject to a condition that Baker Weeks would engage exclusively in brokerage activities and not participate as a managing underwriter or banking group member in any underwriting.[119]

Two months later, the TSE denied an application by Baker Weeks for approval under an exchange by-law of the transfer of ownership. The position of the board of governors of the exchange was that it was bound by the recommendations of the Moore Committee (as it had declared in a notice to members in 1970). Since those recommendations were that the grandfather clause be withdrawn if the firm's change of ownership would make it a "different organization" and since the board concluded that the transfer did have this effect, approval had to be denied.

Baker Weeks appealed to the OSC for a hearing and review. The exchange defended the board's decision but asked that if it had been in error, the exchange be allowed to put the matter to a membership vote. The commission concluded that the exchange did not have the power to deal with transfers of nonresident ownership, since the province had taken over the regulation of this subject. And in any case the board of governors of the exchange was wrong in concluding that it was bound by the Moore Committee recommendations. Further, the board was wrong in deciding that a "different organization" would result from the change in ownership and it would be an abuse to permit a vote on the matter. The exchange was directed to approve the change in ownership.[120]

The fourth case involved the same firm. The U.S. parent, Reynolds Securities Inc., had merged with Dean Witter to form Dean Witter Reynolds Inc., in 1977. Reynolds Securities (Canada) Ltd., the successor to Baker Weeks, applied to the Montreal Stock Exchange, to the Quebec Securities Commission, and to the Ontario Securities Commission for approval of the change in foreign ownership. The Membership Committee of the Montreal exchange recommended that the change be approved without putting the question to a membership vote. The governors of the exchange,

118 *In re* Baker Weeks of Canada Ltd., [1976] OSC Bull. 284, 287 (October).

119 No reason was given for this limitation. It is particularly significant in view of the apparently substantial concentration in Canada of underwriting (*see* note 36 *supra*) and the probable fear of those in the business that well-capitalized competition would hurt them.

120 *In re* Baker Weeks of Canada Ltd., [1977] OSC Bull. 32 (February).

however, referred the question to the members. Of the fifty-eight members, twenty-five voted to approve the change and fifteen voted against approval. Since the exchange by-laws require a two-thirds majority for approval, the request was turned down. At the same time, the Quebec Securities Commission had consented to the change in ownership for registration purposes, so Reynolds Securities (Canada) appealed to the commission to reverse the exchange's disapproval, which it did.[121] The commission unanimously agreed that the vote of the members was an act of the exchange and subject to review, and that in the absence of specific regulations governing the transfer of foreign ownership (regulations that would be subject to commission review) the exchange had no basis for denying approval to Reynolds Securities (Canada).

The Ontario commission came to a different conclusion. Quoting section 6d(3) of the Ontario Securities Regulations,[122] which requires a material or unique service not substantially available from other registrants, the commission concluded that the requirements were not met, and that approval for the change could not be given. However, the commission did conclude "that it would be in the best interests of Ontario investors and the Canadian capital markets to permit the Applicant to continue its Ontario registration".[123] So it recommended that Reynolds Securities (Canada) apply to the Ontario cabinet for a change in the regulations. It also noted that its denial of approval for the change in

121 9 QSC Bull., No. 9 (Decision 5460, March 7, 1978).

122 Ontario Securities Regulations, s. 6d(3) and (4) reads as follows:

> "Upon the application of a non-resident controlled registrant, the Commission, where it is satisfied,
>
> "(a) that the non-resident controlled registrant provides material or unique service to Ontario investors not substantially available to those investors through other registrants; and
>
> "(b) the non-resident and his associates or affiliates have made reasonable efforts without success to obtain resident Canadian purchasers for the equity shares over which they exercise control or direction of the non-resident controlled registrant and that under the control or direction of the proposed non-resident, the non-resident controlled registrant would continue to provide the material or unique service to Ontario investors; or
>
> "(c) the continuation of the material or unique service to Ontario investors is dependent upon continued nonresident control or direction,"
>
> and that to do so would not otherwise be prejudicial to the public interest, may permit a material change in non-resident ownership, control or direction of the non-resident controlled registrant subject to such terms and conditions as it may impose.
>
> "(4) Upon an application of a non-resident controlled registrant, the Commission may exempt the non-resident controlled registrant from the obligation to comply with clause (c) of subsection 1, upon such terms and conditions as it may impose, where it is satisfied that to do so would not be prejudicial to the public interest."

123 *In re* Reynolds Securities, [1978] OSC Bull. 101, 108 (March). The decision is being appealed to the Ontario Court of Appeal.

ownership did not automatically terminate Reynolds Securities (Canada)'s registration, and indicated that it would give the firm a reasonable time to approach the cabinet before taking any action to terminate.

The initial Baker Weeks case is particularly interesting in that it displays a growing willingness on the part of the OSC to oversee decisions of the TSE with respect to membership. Foreign ownership is part of the more general issue of control of membership and the self-regulatory organizations have generally been left to operate as "private clubs". In 1973, Lafferty, Harwood & Partners Ltd. appealed to the OSC from the TSE's refusal of membership. Questions were raised in the case as to the propriety of past actions of the firm but some language of the OSC decision (affirming the refusal) is most interesting:

> "In the first place no one has the right to be a member of the Exchange in the way that it may be said an individual has a general right to carry on any lawful trade he chooses subject to compliance with whatever regulatory requirements there may be...the fact remains that it (the Exchange) is a private corporation and like any private corporation the existing membership may be given the power to decide who may and may not become members."[124]

The decision did, however, include this statement that suggests less than a completely free hand on the part of the exchange:

> "If their [the Governors'] standards were not consistent with our views of the public interest or their discretion were not exercised fairly, such as an absence of evidence upon which their conclusions could be supported, we would not hesitate to intervene."[125]

There seems to be evidence of some tendency on the part of the Ontario commission to assert jurisdiction over membership decisions, but the privacy of the club is still fairly safe except in the nonresident ownership or control area, where the province and the commission have insisted on their own standards.

2. *U.S. Attitudes on Foreign Broker-Dealers*

Attitudes expressed in the United States on the subject of foreign participation in U.S. securities markets may be useful to

124 *In re* the Securities Act and Lafferty, Harwood & Partners Ltd., [1973] OSC Bull. 26, 36 (February), *appeal dismissed*, Lafferty, Harwood & Partners Ltd. v. The Board of Governors of the Toronto Stock Exchange, 58 D.L.R. (3d) 660 (Ont. Div'l Ct. 1975).

125 [1973] OSC Bull. 26, 45 (February).

Canadian policy-makers. While it is true that Canadian securities firms have more to fear from U.S. competitors than U.S. firms have to fear from Canadian competitors, the United States industry is apprehensive over potential competition from European financial institutions, through broker-dealer affiliates.

One set of recommendations prepared in the United States has made the point that denial of NYSE memberships to European broker-dealers may simply lead to a "Euro-third market" – a European over-the-counter market in NYSE listed stocks.[126] This is a point that will not be lost on Canadians. Competition between U.S. and Canadian securities markets is discussed in detail in another part of this paper,[127] but briefly, there is already a "U.S.-third market" in some Canadian stocks listed on exchanges in Canada and there is a substantial volume of trading on American exchanges in Canadian stocks interlisted on both American and Canadian exchanges.

A New York Stock Exchange committee endorsed a policy of reciprocity for admission of foreigners to U.S. securities markets, saying: "The requirement that U.S. broker-dealers be treated as liberally as domestic firms [in a foreign country] should be a *sine qua non* of U.S. policy on foreign access."[128]

In defining what is meant by "reciprocity" the NYSE committee referred with approval to a policy of "mutual nondiscrimination" endorsed by the Federal Reserve, with respect to banking. This would mean, for banking, that foreign and domestic banks operating in a country would be subject to the same rules.[129] The committee argued that the Glass-Steagall Act which requires a separation of investment and commercial banking should apply to foreigners doing business in the United States. And it was claimed that some foreign banks had interests in U.S. affiliates carrying on both activities.[130] The Treasury has suggested that only foreigners *not* associated with commercial banks be granted direct access to U.S. securities markets.[131] Whether nonbank financial institutions, foreign or domestic, should have direct access to securities markets is still unresolved in the United States.

126 Advisory Committee on International Capital Markets, New York Stock Exchange, Recommendations on Access and Membership by Foreign-Controlled Broker-Dealers to the U.S. Securities Markets (June 1974), *reprinted in, Securities Acts Amendments of 1975: Hearings before Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 94th Cong., 1st Sess. 418, 420 (1975).

127 *See* ch. III *infra*.

128 *See* Advisory Committee on International Capital Markets, *supra* note 126, at 425.

129 *Id.* at 420.

130 *Id.* at 421.

131 *Id.* at 422.

Finally, the committee expressed special concern about Canadian attitudes toward foreigners:

> "The Committee would like to direct special attention to recent Canadian policies towards foreign broker-dealers. Canada is one foreign nation where American broker-dealers have a relatively large number of retail outlets. NYSE member firms alone have about 50 branch offices in Canada. The Canadian securities industry has taken an increasingly rigid and severe stance against the operations of foreign broker-dealers in recent years. This is in sharp contrast to the consideration U.S. authorities are now giving to steps to liberalize foreign broker-dealer access to American securities markets.
>
> "In a joint securities industry release late last year, representatives of the Canadian brokerage industry recommended that the activities of new non-Canadian broker-dealers be restricted to selling domestic issues outside Canada, or trading foreign securities with selected institutions only. Moreover, it was recommended that non-Canadian firms not be permitted to transact business in Canada with the general public.
>
> "At first, it appeared that nonresident-controlled brokerage firms existing before July 1971 were granted grandfather status enabling them to continue to engage in a full range of securities activities within Canada. However, it has come to the Committee's attention that Canadian industry authorities now are taking an increasingly hard line on such activities. For example, there is some discussion about whether the grandfather status is transferrable through sale of the business or not. The Committee is concerned about these recent Canadian actions and believes the Canadian situation bears close watching by the securities industry and the U.S. authorities."[132]

G. BROKER FAILURES AND INSURANCE

In Canada there have not been enough failures of brokerage firms to cause alarm and protection of investor-customers has been left almost entirely to the securities industry.[133] The National Contingency Fund was established in 1968 by the Montreal, Canadian, Toronto and Vancouver stock exchanges, and the In-

132 *Id.* at 425.

133 This discussion summarizes *Honsberger*, ch. V, at n. 285.

vestment Dealers Association. The fund and its sponsors have made no promises and undertaken no obligations but the purpose of the fund is to protect customers of members of the sponsors from losses in case of member bankruptcy. A total of $1,895,000 has been paid out in connection with four bankruptcies.

The Quebec Securities Commission has established the Contingency Group Fund for protection of customers of firms not members of one of the sponsors of the National Contingency Fund and a corresponding fund is maintained by the securities industry in Ontario.

In the United States the stock exchanges for some years maintained contingency funds but brokerage failures and financial problems in the late 1960s prompted Congress to enact the Securities Investor Protection Act of 1970. (The New York Stock Exchange Fund paid out about $100 million from 1968 through 1976.) The act established the Securities Investor Protection Corporation (SIPC), a nonprofit organization of which all registered broker-dealers and members of stock exchanges must be members. (At the end of 1976 membership was 5,168.) Assessments are made on members, based on gross securities business, at a rate in 1977 of 0.5%. The fund balance of the corporation had reached $137 million at the end of July 1977. When the balance reaches $150 million, the corporation may reduce the assessment rate. The SIPC protects customers of insolvent members up to a limit of $50,000 per customer with a limit of $20,000 in the case of claims for cash.

Through the end of 1976, 121 members of SIPC had failed, 103,000 customer claims had been satisfied, and $52.8 million had been advanced from the SIPC fund in connection with these liquidations.

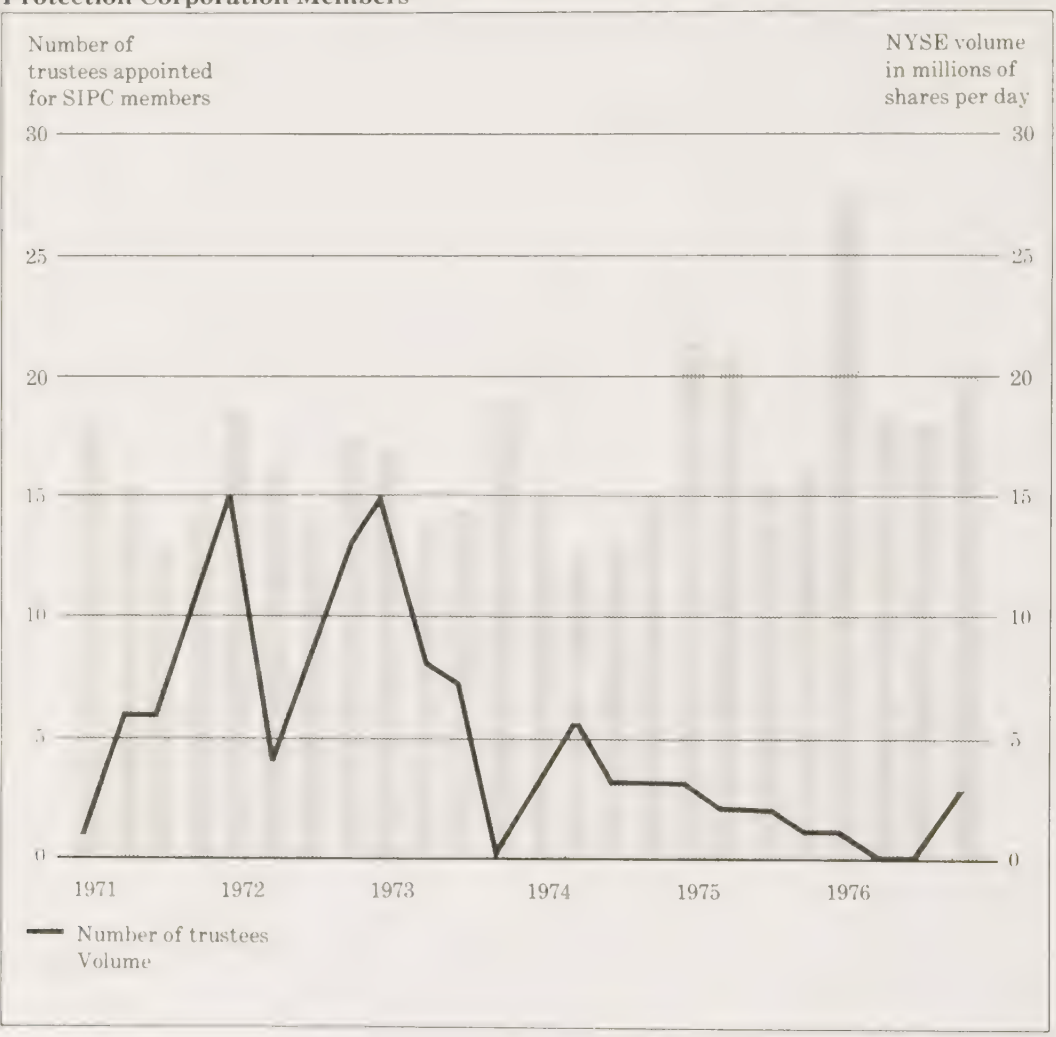
Figure 2 shows a graph of SIPC member failures and NYSE volume. Since 1973 failures seem to be inversely related to volume, although there is no clear pattern in the earlier years. The unfixing of commissions in 1975 does not seem to have had any effect on the number of failures.

H. CONCLUSIONS AND POLICY IMPLICATIONS

Self-regulatory organizations in the securities industry confront a regulatory commission with a number of difficult choices. The first concerns the autonomy of the organizations and the second, closely related to the first, concerns the division of regulatory responsibility between the organizations and the commissions.

The Canadian tradition, like that in the United States, has been to delegate a great deal of regulation to these organizations

Figure 2
New York Stock Exchange Volume and Bankruptcies of Securities Investor Protection Corporation Members



and to give them a great deal of freedom. It was not until the late 1960s that the SEC faced up to the fact that some of the regulatory rules and activities of the stock exchanges in the United States were devoted to investor protection, while others were devoted simply to restraining competition in order to protect the economic interests of the members. Since then both the United States Congress and the SEC have undertaken systematic suppression of anticompetitive activities of the exchanges. Access to membership on an exchange is a matter that has not yet been fully resolved, with the New York Stock Exchange itself in the process of establishing easier and cheaper access for those who are not now members.

In Canada there has been a more subtle recognition of the need to curb anticompetitive self-regulation. The proposed amendments to the Combines Investigation Act and some official commentary on access by foreigners to the Canadian securities market reflect this. But as yet, neither Parliament nor the securities commissions have gone nearly as far as have the United States Congress and the SEC.

As the securities industry in Canada moves closer to a Canada-wide market, access to this market, probably through some self-regulatory organization, will become a critical issue. The regulatory commission with jurisdiction over this market will have to decide whether access is to be controlled by a "private club", or whether it is to be open to all qualified applicants.

With respect to investor protection, substantial delegation of authority to the self-regulatory organizations seems to have worked very well, but there may be some question about leaving the National Contingency Fund and the protection of customers of bankrupt securities firms entirely in the hands of the industry.

A third issue related to self-regulatory organizations concerns competition among them. The current view in the United States seems to be that competition among all marketplaces, exchanges and over-the-counter markets is beneficial. It is not so clear that the form that competition between the Toronto and Montreal Stock Exchanges has taken is beneficial to the securities industry or to its customers. So long as regulation of the stock exchanges remains at the provincial level there is probably not much that can be done to bring about enough uniformity of rules and practices to eliminate unproductive kinds of competition. But a national regulatory commission might want to undertake this.

A fourth issue concerns permissible activities of securities firms, access to these activities and the degree of concentration in them. The range of activities has been left pretty much to the discretion of the self-regulatory organizations, subject, of course,

to statutes limiting entry to a number of activities such as banking. Diversification is an area over which a regulatory commission might want to exercise some jurisdiction. Permissible diversification of firms in the securities industry can hardly be separated from access to the securities industry by firms not outside it. Money management is a good example of this interrelationship. If securities firms are to be permitted to manage money, then should money management firms be permitted to acquire memberships on a stock exchange? This question now confronts the SEC, and has proved to be extraordinarily difficult to answer.

There seems to be some evidence that underwriting is highly concentrated in the Canadian securities industry. Although there may be good reason for this, there may also be some undesirable anticompetitive arrangements that tend to keep the business concentrated. A regulatory commission may wish to take some action here, although the matter can perhaps be left to competition legislation.

Although it appears that concentration is substantial in underwriting, it is hard to be precise simply because the data that would indicate the degree of concentration in all aspects of the securities industry are either nonexistent or treated as highly confidential by the self-regulatory organizations and their members. At the least, a regulatory commission needs to know what the degree of concentration is. And this knowledge is only the beginning of the information gathering that is so crucial to setting policy. The regulatory commissions at present know very little about the economics of the securities industry, something to be discussed in chapter III.

The capital needs of the securities industry constitute one aspect of the economics of the industry that will probably call for some decisions before long. There appears to be evidence that the Canadian securities industry would be stronger and certainly less fearful of foreign competition if it were better capitalized. The rules of the self-regulatory organizations at present stand in the way of substantially increased capitalization and a regulatory commission may simply have to interfere.

Foreign ownership, capitalization, and competitive strength are all closely bound together. Ontario and Québec are the two provinces that have taken some initiative in establishing rules about foreign ownership. The rules, at least in Ontario, have conflicted with the preferences of the Canadian-owned firms. Differences between the attitudes of the two provinces are easily understandable, given the dominance of the Ontario-based firms in the industry. A clear federal policy on this subject, administered by a national regulatory agency, would be very helpful.

Chapter III
Commission Rates and the Economics of the Canadian Brokerage Business

Careful analysis of the economics of the brokerage business began in the United States only in 1968 when the Department of Justice challenged the fixed minimum commission rates of the New York Stock Exchange. In Canada the process began in 1974 when the Quebec Securities Commission asked the Montreal Stock Exchange to explain why its rates should not be competitive. It was intensified in 1976 when the Ontario Securities Commission questioned fixed minimum rates on the Toronto Stock Exchange.

Fixed rates were abolished on the New York exchange in May 1975 and the analysis that preceded that decision has been replaced by evidence on the consequences of the switch to negotiated rates. In Canada the arguments of the stock exchanges persuaded the Ontario commission to continue with fixed minimum rates and the Quebec commission has gone along with that decision. In 1977 the analysis undertaken by the TSE was directed not to continued justification for fixed minimum rates but to support a particular fixed rate structure.

Since the issue of fixed commission rates is still alive in Canada, although it has been settled in the United States, it may be useful to review briefly the economic arguments and analysis that were presented in the United States before the switch to negotiated rates in 1975, as well as the reports on the consequences of abandoning fixed rates there.

A. THE UNFIXING OF COMMISSION RATES IN THE UNITED STATES

In the course of a general review by the SEC in 1968 of commission rates on the New York Stock Exchange, the United States Department of Justice issued a direct challenge to the concept of fixed minimum rates. The rates at that time were those shown in table 35. The New York Stock Exchange responded to the challenge largely by way of an economic study prepared for it in 1970 by the consulting firm National Economic Research Associates.[134] But in August 1968, two years before this report was completed, the exchange published a defence of fixed minimum commission rates in terms of the dire consequences it believed

134 National Economic Research Associates, Inc., Reasonable Public Rates for Brokerage Commissions (2 vols. 1970) (Report to the Cost and Revenue Committee of the New York Stock Exchange).

Table 35
New York Stock Exchange Minimum Brokerage Commissions (Non-Member Rates)

Before May 1, 1975

On first 1,000 shares (per round lot)		On excess over 1,000 shares (per round lot)	
Money involved	Commissions	Money involved	Commissions
First $400	2% plus $3	$100–2,800	1 2% plus $4
Next $2,000	1%	$2,800–3,000	same as $2,800
Next $2,600	1 2%	$3,000–9,000	1 2% plus $3
Above $5,000	1/10%	Above $9,000	1/10% plus $39

Source: New York Stock Exchange.

would follow from competitive rates.[135] The exchange argued that the quality of the central auction market – that is, the New York Stock Exchange market – would deteriorate because of a loss of incentive for brokers to belong to the exchange. Economists not associated with the exchange replied to this argument that there was no reason to believe that the quality of the marketplace itself would deteriorate, but that the value of a seat on the exchange might well decline. This decline would, of course, be unwelcome to the exchange membership, but need not be a matter of concern to the investing public or to a regulatory authority. Indeed, some economists argued that price competition among brokers might well lead to lower commission rates and an increased volume of trading on the NYSE, as it became more competitive with the third market (the over-the-counter market in listed stocks).[136]

The exchange made a second argument to the effect that various services to investors, including research, advisory and communication services would probably decline if commission rates became competitive and fell below the fixed minimum levels. The answer that came from various economists was simply disagreement with this conclusion; if the services mentioned are truly valuable to investors, then investors will buy them one way or another.

A third argument raised by the exchange was to the effect that with competitive rates large investors would probably be treated better than small investors. The economists' reply to this argument was that under fixed commission rates large investors were discriminated against. Their trades were more profitable to brokers than were the trades of individual investors and this discrimination might be expected to disappear with broker price competition. This argument differed somewhat from the first two in that it went to the policy question whether the commission rate structure should be deliberately designed to favour individual investors over institutional investors, as the fixed commission rate

135 NYSE, Economic Effects of Negotiated Commission Rates on the Brokerage Industry, The Market for Corporate Securities, and the Investing Public (August 1968).

136 Chris McEvoy has discussed the effects of fixed minimum commissions and declining competition among jobbers on the London Stock Exchange. In 1974, financial institutions in the U.K. set up their own computer-based block trading system known as ariel (Automated Real-Time Investment Exchange Ltd.). This system is analogous to the Instinet System in the United States, which is largely responsible for the "fourth market" in that country, the institution-to-institution market that makes no use of securities firms. McEvoy suggested that in view of the predictions that in the 1990s, 70% of the equity in U.K. companies will be held by institutions, the ariel system may divert substantial trading from the stock exchange. *See* McEvoy, *Economic Efficiency and the Stock Exchange*, 2 Managerial Finance 330 (1976).

structure on the New York Stock Exchange and the old fixed commission structure on the Toronto Stock Exchange almost certainly were. The question of relative value of institutional trading and individual trading to the quality of the marketplace, and whether one should be required to subsidize the other is discussed later.[137] Briefly, there is no clear-cut reason for a subsidy.

Finally, the NYSE raised the argument of probable destructive competition if commission rates were to be unfixed. The exchange predicted that large, diversified firms would cut prices drastically and eliminate their small competitors, regardless of the efficiency of the latter. It was the prospect of destructive competition that the New York exchange seemed to rely on most in its defence of fixed rates. And it was this same argument that the TSE pushed hardest in 1976 in defence of its own fixed rates. In fact the predicted destructive competition has not taken place in the United States in the three years since fixed commission rates were abandoned, but that does not prove that it cannot take place at some time in the future. Volume on the exchange has been substantial since May 1975 and destructive competition would be expected to take place only in periods of very low volume. So it is still worth reviewing briefly the case that was made for its dangers.

First, the very term "destructive competition" suggests something "bad". Indeed, for the victims within the industry – the firms that are forced into failure or mergers – destructive competition is "bad". But it is not so clear that destructive competition is bad for the customers of the industry, or so bad that price-fixing is a preferred alternative. Destructive competition is usually seen as taking the form of price-cutting until all or most of the firms in an industry are selling their product below total cost for an extended period of time, long enough to bring about a number of failures. It may be argued that customers are injured in this process because they are permanently deprived of the services of the firms that fail. This argument has some merit for an industry into which entry is extraordinarily expensive or otherwise difficult. The railroad industry might be an example. Steel or cement might be others. But the brokerage industry is characterized by relative ease of entry. Firms that fail in recessions are easily replaced in better times. The capital needs for starting a brokerage firm are not extraordinary and the employees of firms that fail are probably available to work for new firms. It is unlikely that the disappearance of any firm in the brokerage industry, particularly

137 In ch. V *infra*

a financially weak firm, will result in a permanent loss of service to the investing public.

A second unattractive consequence of destructive competition may be wide fluctuations in the price of the brokerage service. In times of very low trading volume one might expect drastic price-cutting with substantially higher charges for brokerage services during periods of high volume. The impact of commission costs on the investing public, including the elasticity or response of trading volume to changes in commission rates, is still largely unknown. But both the New York and Toronto stock exchanges have expressed the opinion that the elasticity is quite low and that investors are not very much affected by the level of commission rates.

Finally, it can be argued that destructive competition will lead to the failure of the financially weak firms, even though these firms may be efficient suppliers of services to the investing public, and to increased concentration of the brokerage business in a few well-financed firms. This was the consequence emphasized most by the New York and Toronto exchanges. Neither exchange demonstrated why increased concentration would necessarily be detrimental to the interests of the investing public but it is certainly plausible that this would be the case.

The elements of destructive competition and the conditions under which price-fixing is in the public interest have been carefully set out by F.M. Scherer.[138] Destructive competition begins with fluctuating total demand in an industry where fixed costs are high, and variable costs low. The New York Stock Exchange said that around 50% of the total costs incurred by member firms in their commission business were fixed. Suppose the average cost of handling a brokerage transaction is $60, half of which represents fixed costs (office rent, lease of a computer and so forth), while the other half represents variable cost, the out-of-pocket expense for a transaction. Then as industry volume declines, a firm is tempted to sustain its own volume by reducing price to somewhere between $30 and $60, say $40. At this price the firm will cover its out-of-pocket expense and earn $10 towards fixed costs.

In cutting price, of course, the firm has to consider whether it is more profitable to do a small volume at, say, $50, or a larger volume at $40. But if the cost structure of our firm is characteristic of the entire industry, there will not be much choice. In a fight to stay in business all firms will cut prices to something not much above $30 and there may be virtually no volume available at $50.

138 *See* F. Scherer, Industrial Market Structure and Economic Performance 192-206 (1970).

It is at least better to earn $10 towards fixed costs than nothing at all. But if these conditions continue for long and the firm is simply unable to cover all of its fixed costs, its resources may be exhausted.

Scherer went a little further to see whether the danger of destructive competition justifies price-fixing. If the securities industry were affected in the manner described above in times of low volume, then we would expect firms to raise their prices in times of high volume to make up for their losses. The question is whether the public is better served by high prices in good times and low prices in bad times or by the same fixed prices at all times.

Scherer concluded, first, that highly inelastic marginal costs argued in favour of fixed prices. Highly inelastic marginal costs mean that as volume declines so does the out-of-pocket expense for each transaction, and Scherer saw this as quite likely to happen in an industry with high costs, operating close to capacity. One might imagine this marginal out-of-pocket cost as including some overtime, and other extraordinary expenses, when the firm is at or close to capacity. As volume subsides so do these extraordinary expenses. The result is that the price can fall even more sharply than in the scenario above. The marginal cost may drop to only $25 from $30. So the price might drop to $35 rather than $40. This price would still leave a $10 contribution to fixed costs, so the firm is no worse off. But Scherer pointed out that in *good times* this firm must raise its prices in order to achieve a satisfactory average profit and that the combination of the high price in good times and the low price in bad times would tend to be *higher* than a constant fixed price. So highly inelastic marginal costs argue in favour of fixed prices.

Next, Scherer pointed out that the elasticity of demand is an important element in a justification of price-fixing. A low elasticity of demand means that customers do not respond to price cuts by increasing their purchases. In the brokerage industry it means that investors and traders do not respond to commission rate cuts by increasing their trading. The result is that as brokerage firms cut their commission rates seeking increased volume, they can only take business away from one another. A low demand elasticity encourages destructive competition. But there is more to it. If elasticity *increases* as volume declines, and some economists argue that this is likely, the combination of high prices in good times and low prices in bad times will be no worse than fixed prices. If the elasticity does not increase, and particularly if it decreases, then fixed prices are more likely to be preferable.

We have already seen that the New York Stock Exchange in making its case for the dangers of destructive competition claimed that about 50% of the costs of commission business are fixed. The

exchange went through two analyses, the first of which simply involved the allocation, as fixed or variable, of all of the member firm costs associated with commission business. The second analysis took the form of a multiple regression in which the dependent variable was total cost of commission business and the independent variables were number of transactions handled by each firm and six categories of firm size. From this analysis the NYSE study concluded that the marginal cost for a transaction was $20.65 and the fixed cost varied from about 25% of total costs for the largest firms to something over 50% for the smallest firms. For most of the firms, fixed cost was about 50% of total cost. H. Michael Mann, applying a better regression analysis to the same data, came up with a marginal cost of $26.76 per transaction and fixed costs ranging from about 20% for the largest firms to a little over 40% for the smallest firms.[139] But as Mann pointed out, the whole exercise is somewhat suspect because the cost of a brokerage transaction varies a great deal from one transaction to another. It just is not plausible that the same marginal cost applies to all transactions of all brokers. In any case, the exchange continued its regression analysis to deduce a long-run marginal cost per transaction of $\$31.34 - (2.16 \times 10^{-6}) \times$ the number of transactions per year which is a slightly decreasing function of the number of transactions indicating some economies of scale, that is, large firms have an inherent advantage over small firms. But Mann, performing a similar regression analysis, concluded that the long-run marginal cost was $25.57 and did not change with increased volume.

Harold Demsetz used a slightly different method of analysis to conclude that the average *total* cost per transaction on the New York Stock Exchange declined from about $46 for the firms with the smallest volume (averaging 19,000 transactions per year) to about $28 at a volume of 200,000 transactions per year and then remained fairly constant. His overall conclusion then was very similar to that of Mann, to the effect that economies of scale are not important in the brokerage industry.[140]

A review of the case presented by the New York Stock Exchange and the replies from Mann, Demsetz and other economists, together with the results of some of their own work, convinced R.

139 H. Mann, A Critique of the NYSE's Report on the Economic Effects of Negotiated Commission Rates in the Brokerage Industry, the Market for Corporate Securities and the Investing Public (paper presented to the SEC, 1970). Mann's results are quoted in ch. 5 of R. West & S. Tinic, The Economics of the Stock Market (1971). *See also* Mann, *The New York Stock Exchange: A Cartel at the End of Its Reign*, in Promoting Competition in Regulated Markets 301 (A. Phillips ed. 1975).

140 Statement of Harold Demsetz before the SEC, August 1969, *quoted in* R. West & S. Tinic, *supra* note 139.

West and S. Tinic in 1971, four years before the abolition of fixed minimum commission rates on the NYSE, that negotiated rates would probably lead to a "shake-out" in the brokerage business but not to destructive competition and domination of the industry by a few giant firms. They said "the kinds of economies of scale necessary for this simply do not appear to exist".[141]

1. *Consequences of Negotiated Rates*

Fixed minimum commission rates were abolished in the United States on May 1, 1975, and the SEC monitored the consequences of that event through early 1977. The fifth and concluding report of the commission to Congress[142] answers some of the questions that were raised back in 1968. It does not answer them all. The conditions that might give rise to destructive competition simply have not arisen since May 1975. There has indeed been vigorous price competition but not in the context of very low volume.

Some observations by Greenwich Research Associates in 1977, however, do bear on the question of destructive competition. They reported:

> "In the short run, brokers are striving to build market share by competing simultaneously on two fronts: price and value (or cost). With increasing costs and decreasing revenues, brokers' profits have been under great pressure. So far, most firms have responded solely by striving even harder to increase market share – by increasing costs even more or by reducing the prices of their services even more. And this explains why research and liquidity have both been improving.
>
> "Is it sustainable? Certainly not. Supply cannot long continue to exceed demand, and the supply of research and agency execution services now significantly exceeds the demand for these services. But this anomaly can continue during the near term so long as major firms are fighting for market position and market share....
>
> "Over the next year or so, we expect the number of suppliers to be reduced by several firms merging or closing. The intriguing question is whether this reduction in the number of suppliers will be so great as to create a

141 R. West & S. Tinic, *supra* note 139, at 139.

142 Securities and Exchange Commission, Fifth Report to Congress on the Effect of the Absence of Fixed Rates of Commissions (May 26, 1977). The economic analysis of the brokerage industry was carried forward to the end of 1977 in SEC Staff Report on the Securities Industry in 1977 (May 22, 1978).

situation in which the demand for service exceeds supply, because only then will brokers' prices and margins increase."[143]

The New York Stock Exchange had predicted that brokers and trading would leave the exchange and that the quality of trading would decline. The SEC reported that the share of trading in New York-listed stocks handled on regional exchanges and in the third market showed no significant change following the introduction of negotiated rates. Although these two markets held a slightly smaller fraction of total trading in 1976 than they held in 1974 and earlier years, there was no significant difference between their share early in 1975 when rates were still fixed and in 1976 when rates were competitive. The quality of the exchange market, as measured by stock price volatility, did not change significantly over the period of unfixing commission rates. Liquidity generally improved after rates became negotiable but this was largely the result of an increase in the volume of trading.

The SEC did not report on services to investors,[144] but did discuss the emergence of "discount" brokers offering executions without other traditional services. These firms are generally not members of the exchange, but deal through correspondents. Most have a single office and do not employ registered representatives or solicit orders except through media advertising. A sample of twenty such firms accounted in 1976 for under 0.4% of commission revenue of NYSE members doing a public business. Over 96% of their revenue was from commissions and margin interest and they were quite profitable with average returns on equity of 60.2% and on total capital of 42.6%. (Their capital was 17.2% of total assets compared to 10.2% for NYSE members.)

Commercial advisory services appeared to be flourishing in 1976 and 1977 and the Value Line Investment Survey has directed advertising specifically to investors who have chosen to do business with discount brokers. Banks are also reported to be paying cash for research services.[145]

Greenwich Research Associates commented in 1977:

"Services provided to institutions by brokers have actual-

143 Greenwich Research Associates, Fourth Annual Report on Institutional Brokerage Services at i-ii (1977).

144 But a Quebec Securities Commission Task Force reported in June 1976 that a substantial number of U.S. firms had increased the number of their analysts, although some firms had closed. On the whole, research services seemed unimpaired. Quebec Securities Commission Task Force, Commission Rates in the Securities Industry 25-26 (June 1976). This report was updated in Quebec Securities Commission Task Force, Updated Report on Commission Rates in the Securities Industry (December 1976).

145 Securities Week (New York), April 19, 1976, at 5-6.

> ly increased significantly over the past two years. Liquidity has improved in every sector of the stock and bond markets, and the quantity and quality of research services have both increased for the second straight year."[146]

The New York Stock Exchange had predicted that institutions would benefit from competitive rates at the expense of individual investors. The greatest reductions in commission rates have certainly been achieved by institutions. For them, commissions on all trades dropped from an average of 26¢ per share in April 1975, to 13.3¢ per share in December 1977, a decline of 49%. But for individuals there was also a decline, although a smaller one. The average commission on all trades dropped from 30¢ per share to 24.5¢, a decline of 18%. Expressed as a percent of principal value rather than in terms of cents per share, institutional commissions declined from 0.84% in April 1975 to 0.45% in December 1977, a drop of 46%. For individuals the decline from 1.73% to 1.45% was 16%.[147]

For small trades, however, institutions received a more substantial decrease in commission rates than did individuals. For transactions involving less than 200 shares institutional commissions declined from 60¢ per share to 40.4¢, a drop of 33%. For individuals commissions fell from 50¢ per share to 48.7¢, a decline of 3%. For very large transactions on the other hand – 10,000 or more shares – institutional commissions declined from 15¢ per share to 8.9¢ per share, while individual commissions declined from 9¢ per share to 5.7¢ per share.

One discount broker doing business with individuals advertises commission rates of 40¢ per share on odd lots and the first 100-share round lot, plus 30¢ per share on the second 100 shares, plus 20¢ per share on the third 100 shares, plus 10¢ per share on the balance of an order. In addition, the rates guarantee a discount of 30% from the old New York fixed rates, subject to a $25 minimum. Table 36 shows the commissions for different share prices and different order sizes.

Overall then, institutions appear to have derived more benefit from price competition than individual traders. But individual traders saw their commission rates decline. And individuals could achieve substantial savings by turning to discount brokers.

The SEC conclusions are consistent with what can be observed in the securities markets. Commercial banks have increasingly put up their commission business for bids and for large banks these bids appear to have reached 9¢ or 10¢ per share, with a few at 8¢,

146 Greenwich Research Associates, *supra* note 143, at i.

147 SEC Staff Report, *supra* note 142, exhibit 14. The report noted, at 17, that

and some, for index funds, at 4.5¢. (The bids and the rates paid by large banks are regularly reported in *Securities Week*. In November 1977, *Securities Week* also reported pressure by the Comptroller of the Currency on banks in the south, apparently smaller banks, to seek lower commission rates. South Carolina National Bank, with only about $100 million in equity trust assets, put its commission business for orders under 1,000 shares up for bids. Merrill Lynch won, with a rate between 6¢ and 6.4¢ per share.) For large mutual fund groups executions at 5¢ per share seemed feasible in August 1977 when the Fidelity Funds group worked out an arrangement at this rate with Loeb Rhoades and some independent floor brokers. Subsequently, a number of large money management organizations have achieved a 5¢ target. Early 1978, however, saw a halt to the slide in rates, and some firms began to implement small increases, especially on retail business.

For the brokerage industry the period of price competition was one of high volume of trading with a high level of securities commissions and income. Brokerage commission revenue in 1976 was just 2% below revenue under fixed rates in 1972, a very good year, and 1977 revenue was off 11% from 1976. Institutional firms were the ones most affected by price competition. They showed a decline in securities commission revenue in the second quarter of 1975 following the unfixing of commission rates. All other categories of firms experienced an increase in securities commissions during this quarter. But after that second quarter of 1975 through 1977, the institutional firms held their share of commission revenue. These firms were more profitable than the brokerage industry as a whole when commission rates were fixed but since rates became negotiated their profits have trailed the industry average. Table 37 shows a measure of the impact of negotiated rates on the commission revenue of four classes of firms for the fourth quarter of 1976. Rates of return on equity capital for seven categories of firms for 1976 and 1977 are shown in table 38. Interest expense was a major factor in the 1977 decline.

Concentration of trading, as measured by the percent of securities commission revenue accounted for by the ten largest firms, increased somewhat after commission rates became negotiated (see table 39). But there had already been a steady increase in concentration from as far back as 1972. There was no evidence that the abandoning of fixed commission rates changed this trend.

Commission rate competition has been associated with a high rate of mergers among U.S. brokerage firms in the last year or so.

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individuals probably paid even lower commissions in 1977, because the figures quoted do not reflect the rates of "discount brokers".

Table 36
Comparison of Stock Commission Rates: Old New York Stock Exchange vs. Shearman, Ralston Inc.

As of January 1978
In dollars

Share price	Number of shares							
	50		100		200		300	
	Old NYSE	S/R	Old NYSE	S/R	Old NYSE	S/R	Old NYSE	S/R
$5	11.17	25.00	19.48	25.00	38.97	27.28	58.45	40.91
$10	17.11	25.00	29.70	25.00	59.40	41.58	79.60	55.72
$15	23.05	25.00	37.42	25.00	72.47	50.73	95.63	66.94
$20	27.32	25.00	45.14	30.00	83.16	58.21	116.75	81.73
$25	31.19	25.00	52.87	38.00	93.85	65.70	113.52	90.00
$30	35.05	25.00	58.21	40.00	109.30	70.00	150.28	90.00
$35	38.91	25.00	63.56	40.00	120.47	70.00	167.05	90.00
$40	42.77	25.00	68.90	40.00	131.65	70.00	183.82	90.00
$45	46.63	25.00	74.25	40.00	142.83	70.00	200.58	90.00
$50	50.49	25.00	77.22	40.00	154.01	70.00	217.35	90.00
$60	55.84	25.00	80.73	40.00	161.45	70.00	242.19	90.00
$70	61.18	25.00	80.73	40.00	161.46	70.00	242.19	90.00
$80	66.53	25.00	80.73	40.00	161.46	70.00	242.19	90.00
$90	71.87	25.00	80.73	40.00	161.46	70.00	242.19	90.00
$100	77.22	25.00	80.73	40.00	161.46	70.00	242.19	90.00
$125	80.73	25.00	80.73	40.00	161.46	70.00	242.19	90.00
$150	80.73	25.00	80.73	40.00	161.46	70.00	242.19	90.00
$200	80.73	25.00	80.73	40.00	161.46	70.00	242.19	90.00
$250	80.73	25.00	80.73	40.00	161.46	70.00	242.19	90.00
$300	80.73	25.00	80.73	40.00	161.46	70.00	242.19	90.00

		1,000		2,000	
	S/R	Old NYSE	S/R	Old NYSE	S/R
3.51	61.96	150.88	105.62	263.30	184.31
5.24	80.67	213.62	149.53	375.08	260.00
3.42	103.89	269.51	160.00	449.60	260.00
5.36	110.00	325.40	160.00	499.28	260.00
4.31	110.00	362.66	160.00	548.96	260.00
2.25	110.00	399.92	160.00	598.64	260.00
0.20	110.00	424.76	160.00	648.32	260.00
8.14	110.00	449.60	160.00	698.00	260.00
6.77	110.00	474.44	160.00	747.68	260.00
5.40	110.00	499.28	160.00	797.36	260.00
4.66	110.00	548.96	160.00	896.72	260.00
7.50	110.00	598.64	160.00	996.08	260.00
3.65	110.00	648.32	160.00	1,095.44	260.00
3.65	110.00	698.00	160.00	1,194.80	260.00
3.65	110.00	747.68	160.00	1,294.16	260.00
3.65	110.00	807.30	160.00	1,542.56	260.00
3.65	110.00	807.30	160.00	1,614.60	260.00
3.65	110.00	807.30	160.00	1,614.60	260.00
3.65	110.00	807.30	160.00	1,614.60	260.00
3.65	110.00	807.30	160.00	1,614.60	260.00

Table 37
Estimated Revenue Foregone by U.S. Brokerage Industry by Groups of Sampled Firms

Fourth quarter, 1976
In millions of dollars

Group type	Estimated commissions on equity transactions	Estimated percent discount from effective commission rate before May 1, 1975	Revenue foregone	Estimated revenue foregone as a percent of gross revenue
National full-line firms	$221.0	9.6%	$23.6	4.3%
Regional local full-line firms	24.0	11.4	3.1	5.7
Underwriters and general dealers	83.2	20.5	21.0	6.4
Institutional firms	17.5	33.2	8.7	22.1

Source: Securities and Exchange Commission, *Fifth Report to Congress*, *supra* note 142, Exhibit 19-B.

Table 38
Rates of Return on Equity for U.S. Brokerage Industry

1976 and 1977

	1976	1977
Traders and market-makers	43.1%	12.6%
Underwriters and general dealers	38.4	15.8
Commission introducing firms	31.9	23.2
Regional and local full-line firms	30.8	14.3
Institutional firms	29.6	10.0
National full-line firms	28.0	12.2
Commission firms	22.5	8.8

Source: Securities and Exchange Commission, *Fifth Report to Congress*, *supra* note 142, at 45, and SEC, *Staff Report*, *supra* note 142, Exhibit 8.

Table 39
Concentration of Securities Commission Revenue of New York Stock Exchange Member Firms Doing a Public Business

1974–76

	Percent accounted for by 10 largest firms
1974	
First quarter	33.0%
Second quarter	33.6
Third quarter	35.8
Fourth quarter	37.0
1975	
First quarter	37.8
Second quarter	38.7
Third quarter	38.8
Fourth quarter	38.5
1976	
First quarter [a]	42.3
Second quarter [a]	39.8
Third quarter [a]	39.8
Fourth quarter	39.4

a. Revised.
Source: Securities and Exchange Commission, *Fifth Report to Congress, supra* note 142, Exhibit 22.

But the mergers have generally been in response to increased competition of all kinds and in anticipation of still more competition to come with a National Market System (discussed in Williamson, *Capital Markets*[148]), rather than as a result of negotiated commission rates as such. A few mergers have been aimed at rescuing failing firms but most have reflected a conviction that the major firm of the future must be well capitalized and strong in three operating areas: underwriting, trading and distribution. Recent years have seen the giant retailer, Merrill Lynch, develop strength in underwriting, and the leading underwriter, Morgan Stanley, build and acquire strong trading and distribution operations. Some of the most significant mergers in late 1977 have involved firms particularly strong in only one or two of these three areas.

B. ONTARIO SECURITIES COMMISSION HEARINGS, 1976

During the summer of 1976 the Ontario Securities Commission held hearings on fixed minimum commission rates on the Toronto Stock Exchange. The TSE brief contained a number of opinions to the effect that fixed rates should continue but offered almost no economic analysis.[149] The exchange expressed fears that commission rate competition would lead to financial institutions overshadowing brokerage firms, to fewer brokerage firms and therefore fewer independent sources of research, to reduced services for small investors, and to lack of uniformity in commission rates charged to institutions and individuals. All but the first of these are certainly quite likely, especially in view of the United States experience. But what is doubtful and unsubstantiated is that they are harmful to the investor or the marketplace.

The exchange also argued, as had the NYSE, that price competition would lead to destructive competition and shrinkage of the industry. The TSE went further, predicting that this shrinkage would particularly affect the financing of small companies in Canada because of a reduction in broker research.

But if the TSE pinned its defence of fixed rates on any one claim, it was the claim that commission rate competition would accelerate a trend toward institutional dominance of the ex-

148 *See*, *Williamson, Capital Markets*, ch. IV. The SEC reported that for May 1, 1975, through 1977, 93 firms left the New York Stock Exchange and 62 were admitted to membership. Of the 93, 24 remained in business as NASD members and 36 disappeared in mergers; SEC Staff Report, *supra* note 142, at 13-15 and exhibit 11.

149 TSE, In the Matter of the Securities Act, R.S.O. 1970, ch. 426, and, In the Matter of the Toronto Stock Exchange (June 18, 1976) (submission of the Toronto Stock Exchange to the OSC).

change marketplace. Exactly the same argument had been made by the New York Stock Exchange in defence of fixed commission rates. And as we shall see,[150] institutional participation is far more substantial in New York than it is in Toronto. In both markets the institutional share of trading appears to have leveled off in the last five years or so and what is particularly interesting is a comparison for New York between trading in 1974, when commission rates were fixed, and in 1976, when they were negotiated. Individuals accounted for 23% of total dollar volume on the NYSE in both years, with a slight increase in their proportion of share volume from 31% in 1974 to 33% in 1976. Institutions maintained their proportion of share volume at 44.5% but increased their share of value traded from 51% to 54% at the expense of trading by member firms.[151] This suggests that the shift to negotiated rates on the New York exchange has not led to increased dominance by institutions. Whether such an increase, should it take place, would be detrimental to investors and the marketplace is another question. The answer seems to be no but the question is dealt with in some detail later on.

In the absence of open price competition, service competition is bound to border on price-cutting. This was true in the United States before May 1975 and it appears to be true in Canada. The Quebec Securities Commission Task Force referred to the problems the Montreal Stock Exchange has had with "junkets, payment of subscriptions to business magazines or newspapers, rental of equipment or facilities"[152] and described the allocation of commission business by banks as based on reciprocity.[153] More examples were provided in the task force update of its report.[154] A substantial amount of what looks like price competition makes it likely that open and legitimate price competition would not greatly alter the economics of the industry.

1. *The Potter Submission*

Only three careful analyses of revenues and costs useful for analyzing commission rates in the Canadian brokerage business have appeared to date. One, analogous to the studies described above for the New York Stock Exchange, is that by Calvin Potter. This analysis appeared in his submission to the Ontario Securities

150 In ch. V *infra*.
151 New York Stock Exchange, Public Transaction Study, 1976 (January 1977).
152 QSC Task Force Report, *supra* note 144, at 18.
153 *Id.* at 80.
154 QSC Task Force Updated Report, *supra* note 144.

Commission in the course of the 1976 hearings.[155] He dealt specifically with the argument by the exchange that negotiated rates would lead to destructive competition and relied for his Canadian data on the submission of the TSE to the OSC in November 1975 requesting continuance of a 10% surcharge on commission rates.[156] That submission contained fairly extensive cost and revenue data for five classes of members for six- and twelve-month periods through 1973 and 1974 and up to September 30, 1975. He used comparable U.S. data from the first report of the Securities and Exchange Commission to Congress on the effects of the absence of fixed commission rates, covering the period May 1 to August 31, 1975.[157] (The TSE has also published a cost study covering twelve months to March 31, 1975, and twelve months to March 31, 1976,[158] and another covering calendar 1976.[159] Unfortunately, these more recent studies do not provide any breakdown of data by category of member firms.) The categories of firms were those devised by the Toronto Stock Exchange. Potter's definitions are given in table 40.

Potter began with a comparison of the revenue mix of U.S. and Canadian securities firms. His general conclusion was that the two were remarkably similar, at least for the total industry on both sides of the border. For the Canadian industry for April 1 through September 30, 1975, 54.7% of total revenue came from commission income. For the U.S. firms for May 1 through August 31, 1975, commission revenue accounted for 52.3% of total revenue. (The most recent SEC report shows that for the fourth quarter of 1976 the ratio in the United States had dropped to 40%. For twelve months ending March 31, 1976, the ratio for the Canadian firms was down to 50%.)

Potter found that category A, national full-line firms in Canada, were already less dependent on commission revenue than were their U.S. counterparts, but that category B, local firms with a high value per trade (which Potter treated as analogous to American institutional firms) and category D, local firms with medium to low value per trade, derived a very large proportion of their

155 C. Potter, Fixed Minimum Commission Rates versus Competitive Rates for the Toronto Stock Exchange, Submission to the Ontario Securities Commission (May 1976).

156 Toronto Stock Exchange, Submission to the Ontario Securities Commission for the Continuance of the 10% Surcharge on Orders of $5,000 and above (November 14, 1975).

157 Securities and Exchange Commission, First Report to Congress on the Effect of The Absence of Fixed Rates of Commissions (December 1, 1975).

158 Toronto Stock Exchange, TSE Cost Study (June 18, 1976) (Document No. 3 of Submission to the Ontario Securities Commission).

159 Clarkson, Gordon & Co., Toronto Stock Exchange Report on Cost Study of 13 Member Firms (May, 1977).

Table 40
Definition of Categories of Firms

Category	United States	Canada
A	National full-line firms; underwriters	National, diversified firms
B	Institutional firms	Local firms with high value per trade
C	Traders and market-makers; introducing firms; other firms	National, primarily agency firms with medium to low value per trade
D	Regional and local commission firms	Local, primarily agency firms with medium to low value per trade
E	Regional and local full-line firms	Local and regional, diversified firms

Source: Calvin Potter, *supra* note 155.

revenues from commissions, over 90% in fact, well above the ratios for the U.S. firms. (A detailed breakdown of revenue sources, based on more recent data, was given in chapter II.)[160]

If the firms most dependent on commission revenue are the most vulnerable to price competition, then these are the local firms.[161] However, Potter went on to calculate commission revenue as a percent of trading and found that for category B, the local institutional firms, this percent was relatively low. So these firms were already, presumably because of the tapered rate structure, charging below-average commission rates.

Potter also found that for all of the Canadian firms the commission as a percent of the value traded was considerably higher than the percent charged on individual trading in the United States and of course far higher than the percent charged on institutional trading in the United States. The average for all of the Canadian firms was 2.2%. (More recent data from the Toronto Stock Exchange give an average rate of 1.45% for the April–June 1976 quarter. For trades under $5,000 the average was 2.25%.)[162] In the United States, as we have seen, by February 1977 the percentage had reached 1.58% for individuals, down a little from the 1.7% quoted by Potter, and the rate for institutions had reached 0.47%, down from the 0.6% quoted by Potter. Canadian rates were apparently well above American rates.

Potter drew some conclusions with respect to percentage profit margins in Canada compared with those in the United States. For the six months from April to September 1975 Canadian firms showed a lower margin than U.S. firms but for the three fiscal years ending March 31, 1973, 1974 and 1975 the Canadian firms were considerably more profitable. The more recent data indicate that for the twelve months ended March 31, 1976, the margin for American firms was 15.1% while the margin for Canadian firms was 13.3%. For the twelve months to March 31, 1976, the return on capital before income tax was 29% for the American firms and 25% for the Canadian firms. The "profit" measure is a doubtful one at best, since it is calculated *after* salaries to partners

160 *See* table 18 in ch. II *supra*.

161 The Commission Rate Committee of The Toronto Stock Exchange predicted that half of the category B firms would close if commission rates were unfixed. TSE Commission Rate Committee, Paper No. 3, Consensus of Views of the Commission Rate Committee as to the Likely Consequences of a Move to Unfixed Commission Rates in Canada, at 2 (February 3, 1976).

162 Toronto Stock Exchange, *RAMA [Revenue and Market Analysis] Results for the April-June 1976 Quarter*, Notice to Members No. 1387 (October 21, 1976). The average rates in the RAMA studies are generally lower than the rates given by the cost studies, such as that cited in note 158 *supra*. The exchange relies on the RAMA studies

and directors. The report of the Securities Ownership Committee of the Ontario Securities Commission describes the dramatic effect on reported profits of substantial changes in partners and directors' compensation.[163] Data are included in the SEC's fifth report to permit adjustment for this compensation.

The most interesting of Potter's conclusions is probably that presented in table 41. Fixed costs range from 27% of total costs for category D, to 53% for category C, to over 70% for the other three categories.

These ratios of fixed costs are high by U.S. standards but lower than the TSE's own estimates which are shown in table 42. Potter found, when he allowed for different types of firms, that the marginal cost was $\$30.29 - (65.58 \times 10^{-6}) \times$ the number of transactions per year.[164] This result differs from the New York results and particularly from Mann's results by demonstrating a much greater increase in economy of scale with transaction volume. (This difference could, of course, be due to inaccuracies in estimating transaction volume.) The allocations of fixed and variable costs derived by Potter were for the most part not very different from the Toronto Stock Exchange allocations.

For the industry as a whole Potter found high fixed costs but constant returns to scale. The latter meant that large firms did not enjoy lower marginal costs than small firms. But taking account of categories of firms, he found that within these categories there were increasing returns to scale, that is, larger firms did have an advantage. His explanation for the apparently conflicting conclusions was that there are distinct markets for different kinds of brokerage. As table 41 shows, relative advantages in the form of low total cost, low marginal cost, and high margin between revenue and cost tend to offset one another. So it is not surprising that different categories of firms have developed different products or sets of services within the brokerage business that coexist at different costs and revenues.[165] Potter went on to justify the expectation that this coexistence would continue under competitive rates. And this coexistence appears to be about what has happened in the United States, with some shifting in the costs,

163 OSC, Report of the Securities Industry Ownership Committee, *supra* note 20, at 55-56, 61-62.

164 Shaw and Archibald asked 16 firms what was the minimum commission that returned a profit to the firm. The median response was $26. The range was from $9 to $65. 7 D. Shaw & R. Archibald, *supra* note 28, at 46 (The Securities Firm in the Canadian Capital Market).

165 This is borne out by the estimates of profitable commissions referred to in note 164 *supra*. Two of the three highest estimates came from institutional firms and the three lowest came from retail firms.

Table 41
Average and Marginal Agency Revenue, Long-Run Average and Marginal Transaction Costs, and Related Margins, by Category of Firm

1976
In dollars

Category	Estimated number of annual transactions	Annual variable cost	Annual fixed cost
D	14,000	$ 411,320	$ 151,870
E	16,000	179,168	556,350
B	15,300	448,137	1,193,470
C	60,900	1,603,000	1,825,970
A	89,900	2,193,200	5,242,700

Table 42
Agency Business Expenses of Toronto Stock Exchange Firms

12 months to March 31, 1973–75
In thousands of dollars

Category	1973 cost [a]				1974 cost [a]
	Total	Variable		Fixed	Total
A	$ 64,729	$12,955	20%	$51,734	$ 83,587
B	20,556	6,524	32	14,032	29,429
C	27,668	10,728	39	16,940	12,611
D	8,374	3,659	44	4,715	11,021
E	18,681	7,149	38	11,532	9,753
Total	140,008	41,055	29	98,953	146,401

rage nue per saction	Marginal revenue per transaction	Marginal cost per transaction	Unit cost per transaction	Potential discrimination margin
.29	$36.15	$29.38	$ 50.23	0.728
.62	35.75	29.24	46.42	0.525
.03	33.98	29.29	107.29	0.745
.25	27.76	26.28	56.21	0.556
.16	22.22	24.40	82.62	0.675

Source: Calvin Potter, table XIX, *supra* note 155.

			1975 cost[b]			
iable		Fixed	Total	Variable		Fixed
,798	20%	$ 66,789	$ 80,602	$13,358	17%	$ 67,244
,651	35	21,778	23,729	4,273	22	19,456
,028	40	7,583	12,817	4,001	31	8,816
,708	43	6,313	4,236	1,572	37	2,664
,981	41	5,772	6,061	1,887	30	4,174
,166	26	108,235	127,445	25,091	20	102,354

a. 57 TSE firms.
b. 46 TSE firms.
Source: Toronto Stock Exchange, Submission to the Ontario Securities Commission, *supra* note 156, Appendix E.

prices and sets of services (including the innovation of the execution-only service).

2. *The Ontario Securities Commission Decision in 1976*

In a split decision the Ontario Securities Commission approved in 1976 the continuation of fixed rates with a requirement that the TSE submit a new schedule of rates. There was little reasoning in the majority opinion; about all it conveys is a message that the majority did not feel compelled to take an uncomfortable step.[166]

C. THE QUEBEC SECURITIES COMMISSION TASK FORCE REPORT

Reference has already been made to the Quebec Securities Commission Task Force report[167] and the appendix to this paper reproduces chapter II of the report, which describes the U.S. and Canadian commission rate structures up to early 1976. The task force collected data on fifty brokers registered with the Quebec commission and responsible for 96% of the 1975 value of trading on the Montreal exchange. For the whole group, 1975 commission revenue ($139.9 million) was 44% of total revenue ($320 million). This fraction compares with 54.7% for the TSE firms in the TSE and Potter analyses.

Of a total of $140 million in brokerage commissions, 35% was from institutions and 65% from retail customers. For the seven firms deriving over half their commission revenue from institutions[168] institutional commissions were over 80% of the total but these specialized firms accounted for only 17% of institutional commissions. The nine firms deriving over half their commissions from retail customers[169] averaged 60% retail business but still did twice the volume of institutional business done by the seven institutional firms.

Total underwriting revenue for the fifty firms was $67.6 million. The seven firms for which over half of total revenue was derived from underwriting[170] earned 42% of this amount. So

166 *In re* pt. XV of the by-laws of the Toronto Stock Exchange, [1976] OSC Bull. 289 (November). The decision is carefully reviewed in Connelly, *Fixed Versus Negotiated Commission Rates on The Toronto Stock Exchange*, 2 CAN. BUS. L.J. 244 (1977).

167 *See* note 144 *supra*.

168 Alfred Bunting & Co., Gordon Securities, Institutional Securities, Lafferty Harwood & Partners, Loewen Ondaatje McCutcheon, Maison Placements Canada, Research Securities of Canada.

169 Bache Halsey Stuart Canada, Bongard Leslie, Davidson Partners, Dominick Canada, Draper Dobie, Geoffrion Robert & Gélinas, W.D. Latimer, Midland Doherty, Turcot Wood Power & Cundill, Yorkton Securities.

170 A.E. Ames, Grenier Ruel & Cie., René T. Leclerc, Lévesque Beaubien, Molson Rousseau & Co., Tassé & Associés, Wood Gundy.

underwriting was a good deal more concentrated than institutional commission business.

Revenues of all firms fluctuated substantially from month to month in 1975 but apparently the fluctuations were not significantly greater for the firms most dependent on commissions (twenty-six firms derived over half their total revenues from commissions). These firms, however, showed more months of losses. The analysis concluded that fixed costs are substantial but did not attempt to quantify this conclusion.

It appeared that the institutional firms were consistently more profitable than the retail commission firms through 1975, confirming the TSE and Potter conclusions. The underwriting firms were much more profitable than those dependent on commission revenue and this, too, confirmed the other studies' conclusions. Profitability declined steadily for the commission firms over the four quarters of 1975 but the report suggested no reason for this. Figure 3 shows the relationship between MSE volume and rate of return on capital for three classes of firms for 1975.

Table 43 applies U.S. experience to the Canadian industry to forecast the revenue reductions that might result from competitive commission rates.

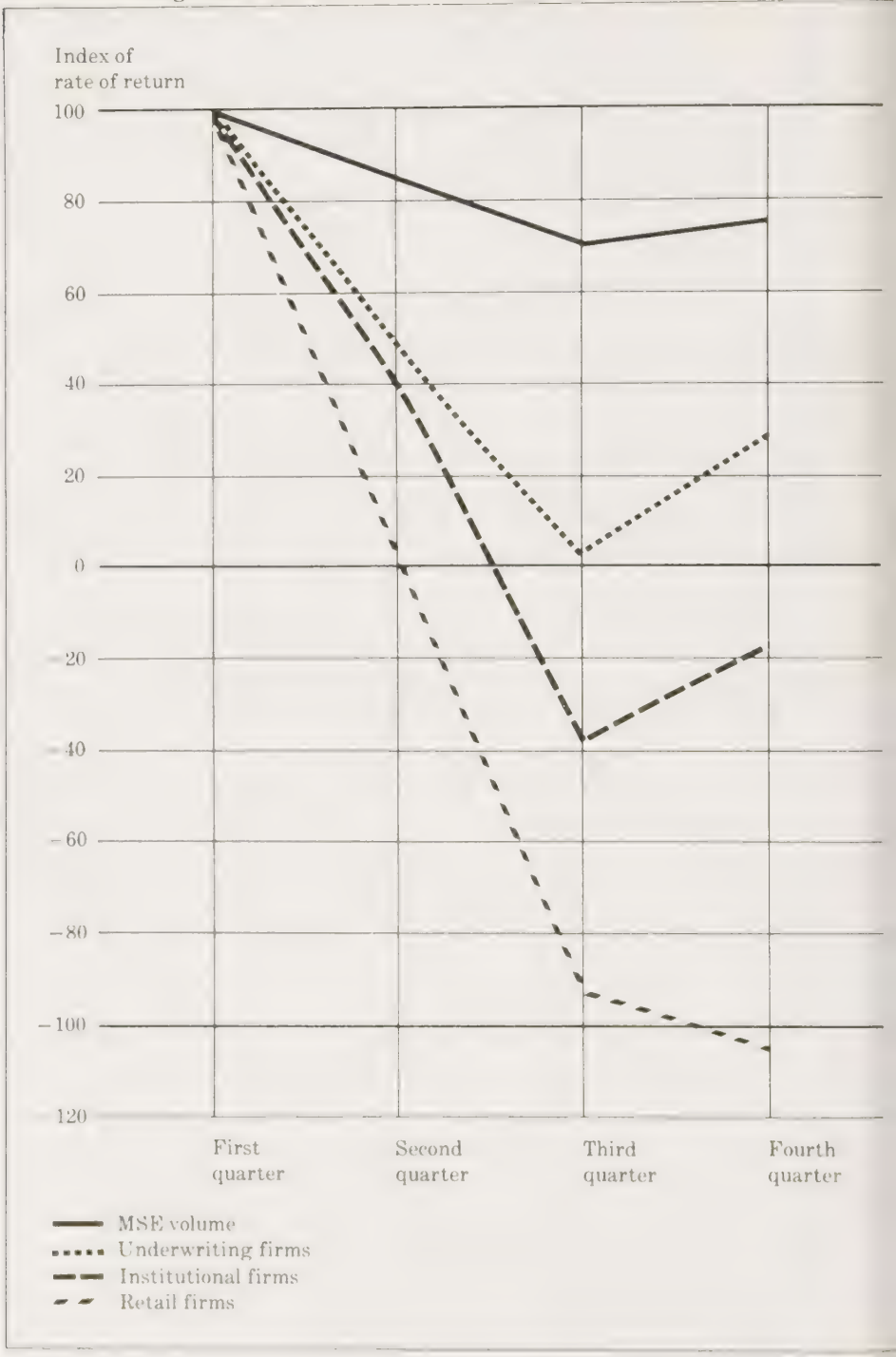
A good deal of the QSC task force analysis was directed at the differences between Québec-controlled and other brokerage firms. (The seven firms with the largest total revenue, aggregating 45% of revenues of all fifty firms, were controlled outside Québec.) Concentration was another element of interest. Figure 4 shows concentration by various kinds of revenue. Underwriting shows relatively large concentration, while institutional commission business shows relatively little (half as much as underwriting) and retail commission business lies between. Concentration in underwriting revenue correlated highly with concentration in capital; but the heavily capitalized firms did not dominate the commission business.

D. COMPETITION BETWEEN U.S. AND CANADIAN MARKETS

As we have seen, one of the issues raised in the U.S. deliberations over fixed or competitive commission rates was the competition among the New York Stock Exchange, the regional stock exchanges, and the "third market". The New York exchange had hoped that Congress or the SEC might eliminate the third market by legislation or by rule but that wish was not granted.

In Canada no significant "third market" has ever developed and although there is competition between Toronto and Montreal, the commission rates are identical on the Toronto and Montreal

Figure 3
Montreal Stock Exchange Volume for 1975, and Rates of Return on Capital for Three Categories of Firms



Source: *Quebec Securities Commission Task Force* (1976).

le 43
othetical Reduction in Revenues and Brokerage Rates
ed on United States Experience[a]

housands of dollars

egory	Number of firms	Reduction of commission revenue		Reduction of total revenue
itutional	7	$ 3,300	35.9%	33.0%
ail	10	1,500	5.3	3.6
lerwriting	7	3,000	17.7	4.4
ers	26	11,800	13.8	5.9
al	50	19,600	14.0	6.1
% or more of total revenues inate from stock exchange missions	26	9,500	15.5	11.0
% or more of total revenues inate from other sources	24	10,100	12.9	4.3
50% of total revenues inate from institutional missions	11	4,600	19.1	12.3
gest firms	8	6,300	11.7	3.9

a. Assumes a 40% decrease in the average institutional brokerage rate.
Source: *Quebec Securities Commission Task Force*, *supra* note 144, table VIII-1.

Figure 4
Categories of Revenue for 50 Largest Firms on the Montreal Stock Exchange, 1975



Source: *Quebec Securities Commission Task Force* (1976)

exchanges. But there is vigorous competition between Canadian and U.S. markets in interlisted stocks. The shares of about seventy-nine Canadian corporations are listed for trading on stock exchanges or on NASDAQ in the United States as well as in Canada. Eighteen are listed on the NYSE, forty-two on the AMEX, sixteen on NASDAQ and three on the Pacific Coast Exchange. These stocks present an unusual opportunity for a Canadian investor to seek better trading conditions in the United States. They are also important stocks in terms of the Canadian marketplace. Forty percent of the value of trading on the TSE in the first five months of 1977 was in these interlisted issues.

The Toronto Stock Exchange has said that "there is an active dealer market in the U.S. in a significant number of TSE stocks which are *not* listed in the U.S., but trade via NASDAQ and the U.S. OTC market – in effect a 'third market' in TSE stocks....In certain stocks, including Moore Corporation, Denison Mines, Falconbridge Nickel Mines, such trading is substantial".[171]

Tables 44 and 45 show a rough comparison between U.S. and Canadian commission rates at mid-1976.[172] (The appendix to this paper contains graphical comparisons for institution size orders taken from the Quebec Securities Commission Task Force report.)

The SEC presents data for different sizes of orders broken down by number of shares rather than by value, while the TSE breaks down orders by value. Table 44 shows the SEC statistics with size of order estimated by assuming an average price of $25 per share. It seems safe to say that for Canadian trading, institutions account for almost all of the orders from $100,000 up, and the 0.73% rate of commission was high compared to the American institutional rates on large trades. (As of the end of 1977 the U.S. institutional rate was down from the 0.4% shown in table 44 to about 0.3%.) Since even on the smallest orders the average American institutional rate was only 1.05%, it seems clear that in general the U.S. trading was cheaper for institutions.

An interesting comparison of commission rates in Canada and in other countries, as of mid-1976, is shown in table 46 taken from a submission to the Ontario Securities Commission by Swiss Corporation for Canadian Investments Ltd.[173] Tables 47 and 48 from the

171 Toronto Stock Exchange, Background Memorandum concerning Principal Transactions, at 39 (May 23, 1977). The memorandum was part of a submission to the Ontario Securities Commission.

172 SECURITIES AND EXCHANGE COMMISSION, FIFTH REPORT, *supra* note 142; Toronto Stock Exchange, *RAMA Results for the April–June 1976 Quarter*, Notice to Members No. 1387 (October 21, 1976).

173 Swiss Corporation for Canadian Investments Ltd., Fixed or Negotiated Rates? (May 14, 1976) (brief submitted to the Ontario Securities Commission).

Table 44
United States Data, Commission in Cents per Share and Percent of Value

April 1975 (old) and June 1976 (new)

Total value of order	Commission							
	Institutions				Individuals			
	Old		New		Old		New	
	Cents per share	Rate of commission	Cents per share	Rate of commission	Cents per share	Rate of commission	Cents per share	Rate of commission
Under 200 shares (under $5,000)	60¢	1.50%	50¢	1.05%	50¢	2.04%	53¢	2.00%
200–999 shares ($5,000–25,000)	46	1.28	33	0.90	33	1.86	32	1.80
1,000–9,999 shares ($25,000–250,000)	28	0.89	20	0.50	20	1.38	19	1.25
Over 10,000 shares (over $250,000)	15	0.57	11	0.40	9	0.76	7	0.50

Source: Securities and Exchange Commission, *Fifth Report*, *supra* note 142.

Table 45
Canadian Data, Commission in Cents per Share and Percent of Value

April–June 1976

Total value of order	Commission		
	Cents per share	Rate of commission	Average order value
Under $5,000	5.2¢	2.25%	$ 1,507
$5,000–9,999	14.7	2.03	6,949
$10,000–19,999	19.2	1.90	13,754
$20,000–99,999	21.1	1.42	37,964
Over $100,000	14.1	0.73	235,267
Total	10.4	1.45	6,574

Source: Toronto Stock Exchange, *RAMA Results*, *supra* note 172.

submission of Burns Fry Limited, give a more direct Canada-United States comparison.[174]

The submissions to the Ontario Securities Commission in the summer of 1976 reflected an awareness of the competitive threat of U.S. markets with some confidence that there was little to worry about. In its submission, the Montreal Stock Exchange reported that for interlisted issues, total 1975 U.S. volume was about 43.9% of the total Canada and American trading. There had been a downward trend in the percentage trading in the United States, from a high of 70.5% in 1969 to a low of 43.9% in 1975, although throughout this period Canadian commission rates were somewhat higher than rates in the United States. There had been, however, a wide variety among the stocks in terms of the percent of trading done in the United States and the trend in that percent.[175]

The Montreal exchange reported some evidence that Canadian financial institutions had shifted orders for some stocks to the United States market and the shift was particularly noticeable in the case of the stocks of four widely-held corporations: Alcan, Canadian Pacific, International Nickel, and Massey-Ferguson. For Alcan and International Nickel most of the total trading is done in the United States while for the other two most is done in Canada. The exchange concluded that the trading statistics, particularly those reflecting the American and Canadian shares of trading following the freeing of commission rates in the United States on May 1, 1975, indicated that a differential in commission rates between the United States and Canada was not likely to lead to a substantial outflow in trading in interlisted issues.[176] But the exchange was sufficiently concerned about such a shift that it advocated that Canadian brokers be forbidden to pass on to Canadian customers the benefits of lower commissions on U.S. transactions in interlisted stocks.[177]

Some Canadian institutions indicated in their briefs to the OSC that they had shifted trading from Canada to the United States to take advantage of lower commission rates there.[178] Other

174 Burns Fry Limited, A Case for Negotiated Commission Rates in Canada (June 1, 1976) (submission to the Ontario Securities Commission).

175 Montreal Stock Exchange, Brief Presented to the Ontario Securities Commission in the Matter of the System of Fixed Minimum Rates of Commission for Exchange Transactions, at I-3–I-17 (June 10, 1976). Most of this U.S. trading is carried out by Canadian, not American brokers; *id.* at IV-8.

176 The Report of the Quebec Securities Commission Task Force was less optimistic; QSC Task Force, *supra* note 144, at 29, 81.

177 Montreal Stock Exchange, brief, *supra* note 175, at IV-6. In its submission of June 1, 1976, Burns Fry Limited suggested that such a prohibition might come about.

178 For example, Mutual Life Assurance Company of Canada and Canada Permanent Trust Company.

Table 46
Comparison of Stock Exchange Commissions on Various Markets of the World

1976
Per 100 share order, in Canadian dollars

Price per share	Canada		New York		Paris	
$5.00	$ 12.50	2.50%	$12.86	2.57%	$ 5.00	1.00%
$10.00	25.00	2.50	19.60	1.96	10.00	1.00
$25.00	44.76	1.79	34.89	1.40	25.00	1.00
$50.00	82.00	1.64	50.96	1.02	50.00	1.00
$75.00	123.00	1.64	50.96	0.68	75.00	1.00
$100.00	164.00	1.64	50.96	0.51	100.00	1.00

ıkfurt		London		Tokyo		Zurich	
00	0.60%	$ 12.59	2.52%	$ 8.00	1.600%	$ 5.15	1.03%
00	0.60	15.00	1.50	10.34	1.034	10.25	1.03
00	0.60	37.50	1.50	17.34	0.694	16.25	0.65
00	0.60	75.00	1.50	35.34	0.707	32.50	0.65
00	0.60	112.50	1.50	52.68	0.702	48.75	0.65
00	0.60	150.00	1.50	65.68	0.657	65.00	0.65

New York: Figures based on commission tariff in force prior to May 1, 1975, with 20% discount. Price per share and commission converted into Can $ at 98.
Paris: Commission is based on the total amount of the order, regardless of share price. Commission includes stamp duty. Conversion rate 0.2105.
Frankfurt: Commission is based on the total amount of the order, regardless of share price. Tariff used for transactions between banks. Conversion rate 0.3870.
London: Commission is based on the total amount of the order, regardless of share price. Conversion rate 1.7980.
Tokyo: The average share price is far below the one in Canada. A share price of 1,000 Yen ($3.27) is unusual. To obtain a meaningful comparison, we applied a share price ratio of 1:30. Conversion rate 0.003275. A 1.018 share order was used.
Zurich: The average share price is far above the one in Canada. To obtain a meaningful comparison, we applied a share price ratio of 1:10. Conversion rate 0.3996. Commission is based on the total amount of the order, regardless of share price. Commission includes federal and cantonal tax.
Source: *Fixed or Negotiated Rates? A Brief on the Subject of Stock Exchange Commissions in Canada*, submission by Swiss Corporation for Canadian Investments Ltd., May 14, 1976.

Table 47
Approximate Commissions Charged by Full-Service Firms in the United States One Year after "Mayday" and Discount from Prior Fixed Rates[a]

As of May 1, 1976

Total value of order	Price per share											
	$10		$20		$30		$40		$50		$60	
$50,000	10¢	29%	16¢	30%	23¢	28%	29¢	31%	35¢	30%	42¢	31%
$100,000	8	33	13	32	18	31	23	30	28	30	33	31
$200,000	7	36	11	35	15	35	19	34	24	31	28	33
$300,000	7	36	10	37	14	36	18	36	21	36	25	36
$400,000	6	N/A	10	N/A	14	N/A	18	N/A	21	N/A	25	N/A
$500,000	5	N/A	9	N/A	12	N/A	16	N/A	18	N/A	22	N/A

a. Expressed in cents per share with percentage discount from old fixed rates. Discounts on large transactions not applicable (N/A), since rates on transactions over $300,000 were negotiable prior to May 1, 1975.
Source: Burns Fry Limited.

Table 48
Fixed Minimum Commission Rates in Canada[a]

As of May 1, 1976

Total value of order	Price per share					
	$10	$20	$30	$40	$50	$60
$50,000	19.50¢	31.45¢	38.37¢	51.17¢	63.96¢	76.75¢
$100,000	14.00	22.58	27.55	36.74	45.92	55.10
$200,000	10.75	17.34	21.16	28.21	35.26	42.31
$300,000	9.67	15.59	19.02	25.37	31.71	38.05
$400,000	9.16	14.72	17.96	23.94	29.93	35.92
$500,000	8.80	14.19	17.32	23.09	28.86	34.64

a. Expressed in cents per share.
Source: Burns Fry Limited, using Toronto Stock Exchange figures.

institutions indicated that they were content with the Canadian marketplace, while still others expressed some surprise that Canadian institutions had not pursued the lower rates available in the United States more aggressively. One submission noted that Canadian bank stocks trade over-the-counter in the United States at somewhat lower transaction costs than are found in Canada.[179]

In discussing the potential for a shift of trading from Canada to the United States, some of the submissions stressed the importance of the quality of the market, particularly its liquidity, observing that a lower commission rate might well be offset by the disadvantage of a poorer market. However, no evidence was presented to indicate that the U.S. market for any of the interlisted stocks was significantly lower in quality than the Canadian market.

In early 1977 the complacency disappeared and the Toronto Stock Exchange became alarmed at the shift of trading from Canada to the United States. Two committees of the exchange, the Market Functions Committee and the Joint Industry Commission Rate Committee, brought some distressing statistics to the attention of the membership and the public. Table 49 shows the percentages of total agency trading and total principal transactions of members of the TSE in interlisted Canadian stocks that were executed in the United States. There was a significant increase in agency trading in the United States, but the actual "slippage" could have been even greater since these figures do not include transactions for Canadian customers by U.S. brokers who are not members of the TSE. Nor do they include American trading over-the-counter in stocks that are not interlisted. In 1977, however, U.S. agency trading dropped a little, principal trading was up a little, and total U.S. trading seemed to have leveled off.

The Market Functions Committee acted first, recommending a reduction from $400,000 to $100,000 in the minimum size trade that may be handled by a member firm as a principal transaction. The proposal was accepted by the membership and ultimately by the Ontario Securities Commission.[180] The committee produced a rather more detailed analysis than is shown in table 49 in order to show that trading in interlisted issues is more concentrated in large orders than is trading in all issues and that a high percentage of large orders (over $50,000) are transacted in the United States. The commission rate proposal came next.

179 Brief of the Investment Counsel Association of Quebec (July 22, 1976) (submission to the Ontario Securities Commission).

180 *See* the discussion in *Williamson, Capital Markets*, ch. II.

Table 49
Slippage in Percentages of Agency and Principal Transactions to U.S. Markets

May 1975–September 1977

Month	Agency	Principal	Total transactions
May 1975	6.94%	33.21%	17.16%
November 1975	10.77	33.07	18.35
March 1976	12.93	36.93	22.93
June 1976	12.87	38.75	23.70
September 1976	15.34	37.99	24.46
October 1976	13.63	35.73	23.55
November 1976	12.47	32.92	21.11
December 1976	16.40	35.95	24.75
January 1977	13.70	38.80	26.10
April 1977	15.70	36.80	24.40
June 1977	14.80	39.90	24.90
September 1977	14.20	40.20	23.90

Source: Toronto Stock Exchange. Data through December 1976 appeared in: Joint Industry Commission Rate Committee, *Presentation of Proposed Commission Rates* (April 4, 1977).

E. THE 1977 COMMISSION RATE PROPOSAL

The Joint Industry Commission Rate Committee proposed a new fixed commission rate structure based on the value of each 100 share lot traded. Commissions would be 3% of the first $500, 2% of the next $1,000 and 1% of the balance, with a discount for large transactions – nothing off the first $5,000, 10% off the next $15,000 and 20% off the next $20,000. On amounts beyond $40,000, the commission would differ according to whether the stock price was less than or greater than $10. Below $10 the rate would be 1% of value; above $10 it would be 10¢ per share. Beyond $1 million rates would be negotiable. (Under the existing rate schedule, negotiation began at $500,000.) Individual traders would be given a 50% discount on "reversal" sales, at the broker's discretion where the purchase and sale of the same stock were executed through the same broker within forty-five calendar days. (This rule has apparently introduced some rate competition.) Finally, a five-day accumulation rule would allow consolidation, for purposes of determining the commission, of orders filled within five consecutive trading days where the total value is at least $100,000. The membership approved on April 19, 1977 (by a vote of seventy-eight to fifteen), and this rate scale was put before the Ontario Securities Commission in June 1977.

The exchange's 1977 submission disclosed the dilemma in which the industry found itself. On the one hand, the recession of 1973–74 had reduced profits and led to attrition in the number of salespeople employed so that firms were eager to increase commission rates. On the other hand, the substantially lower commission rates in the United States were taking institutional trading in Canadian interlisted stocks away from the Toronto market. The task was to produce a rate scale that was attractive to member firms, yet competitive with U.S. rates. These conditions precluded a "flat" rate, one based solely on the value of a transaction. That rate would have to be either too low to satisfy the members or too high to be competitive, and since costs of executing a transaction are almost certainly not directly proportional to the value of the transaction, there is little reason to aim at a flat rate.

In defending the proposed rates the exchange said that "there is a relatively high cost per trade which must be met, regardless of the trade value, and the incremental costs arising from the value of the trade or the number of shares involved is a smaller percentage of the total cost".[181] This conclusion follows

181 Toronto Stock Exchange, Submission to the Ontario Securities Commission regarding the Proposed Commission Rate Schedule, at 20 (May 16, 1977).

from the 1976 data described above and from Potter's analysis. But the cost study commissioned by the TSE for the 1977 hearings provided little support.[182] Clarkson,Gordon & Co. explicitly disclaimed any attempt to separate fixed from variable costs, and in fact expressed doubt that a separation was even practical.[183] We can be fairly sure from the earlier data, discussed above, that fixed costs are substantial (although, as Clarkson Gordon suggested, it is very hard to say just how "fixed" these costs are – leases, after all, can be terminated, computers relinquished, research staffs cut back). And there almost certainly is some minimum marginal cost for a transaction. But how these costs may vary from firm to firm and from category to category of firm the exchange did not say.

Institutional trading was expected by the exchange to involve chiefly shares priced above $10, which was chosen as the dividing point for rates on the portion of a transaction beyond $40,000. For higher priced shares these large transactions were expected to be competitive with trading in the United States. Table 50 compares old and proposed TSE rates with old NYSE rates. Since institutional brokerage firms in the United States were on average charging rates 33% below the "old" New York rates in the fourth quarter of 1976 and institutional customers were achieving discounts of 30% to 40%,[184] the current NYSE commissions can probably be taken to be about two-thirds of the "old" rates. The TSE rates do appear competitive on these very large trades.

1. *The Clarkson Gordon Cost Study*

The Clarkson Gordon study is disappointing in that it makes no attempt to separate fixed and variable costs or at least to identify the minimum cost that might be associated with an execution. Even though this identification is difficult, the proposed rate structure is based on the proposition that there is such a minimum cost and that rates should at least approximately reflect it. The study is also disappointing in that it identifies very different average total costs per transaction for different categories of firm, as did Potter, but makes no attempt to explain the differences. The TSE proposal offers only a distinction between "retail" and "institutional" trades but there must be much more significant differences.

Table 51 analyzes transaction costs for commission transac-

182 Clarkson, Gordon & Co., *supra* note 159.

183 *Id.* at 32.

184 Securities and Exchange Commission, Fifth Report, *supra* note 142.

Table 50
Commissions on Large Transactions[a]

As of May 16, 1977

Total value of order	Price per share				
	$10	$20	$30	$40	$50
$100,000					
Present TSE	14.0¢	22.6¢	27.6¢	36.7¢	45.9¢
Proposed TSE	14.6	19.8	23.2	26.7	30.1
Old NYSE	11.9	18.9	26.3	32.9	39.9
2/3 of Old NYSE	—	12.6	17.5	21.9	26.6
$200,000					
Present TSE	10.7	17.3	21.2	28.2	35.3
Proposed TSE	12.3	14.9	16.6	18.3	20.1
Old NYSE	10.9	16.9	23.0	28.9	34.8
2/3 of Old NYSE	—	11.3	15.3	19.3	23.2
$500,000					
Present TSE	8.8	14.2	17.3	23.1	28.9
Proposed TSE	10.9	12.0	12.6	13.3	14.0
Old NYSE	10.3	15.7	21.1	26.4	31.8
2/3 of Old NYSE	—	10.5	14.1	17.6	21.2

a. Expressed in cents per share.
Source: Toronto Stock Exchange, *Submission to the Ontario Securities Commission*, *supra* note 181, with 2/3 of old NYSE rates added.

Table 51
Analysis of Transaction Costs per Agency Transaction

1976
In dollars

	All firms in survey (13 firms)	Retail (3 firms)	National retail (2 firms)	Diversified (5 firms)	Institutional (3 firms)
Total cost before interest, compensation to producers and bonuses to shareholders	61.59	36.50	43.81	87.32	192.66
Implied compensation to producers at 33-1/3% rate	30.80	18.25	21.90	43.66	N/A
Calculated value of commission revenue from "break-even trade"	92.39	54.75	65.71	130.98	N/A
Average commission revenue from TSE trades	79.62	66.94 [a]	53.47	91.53	235.70
From all agency trades	69.40	51.89 [a]	43.26	86.34	244.67

a. Excludes one retail firm with a large volume of institutional business.
Source: *Clarkson Gordon Cost Study*, schedule 19, *supra* note 182.

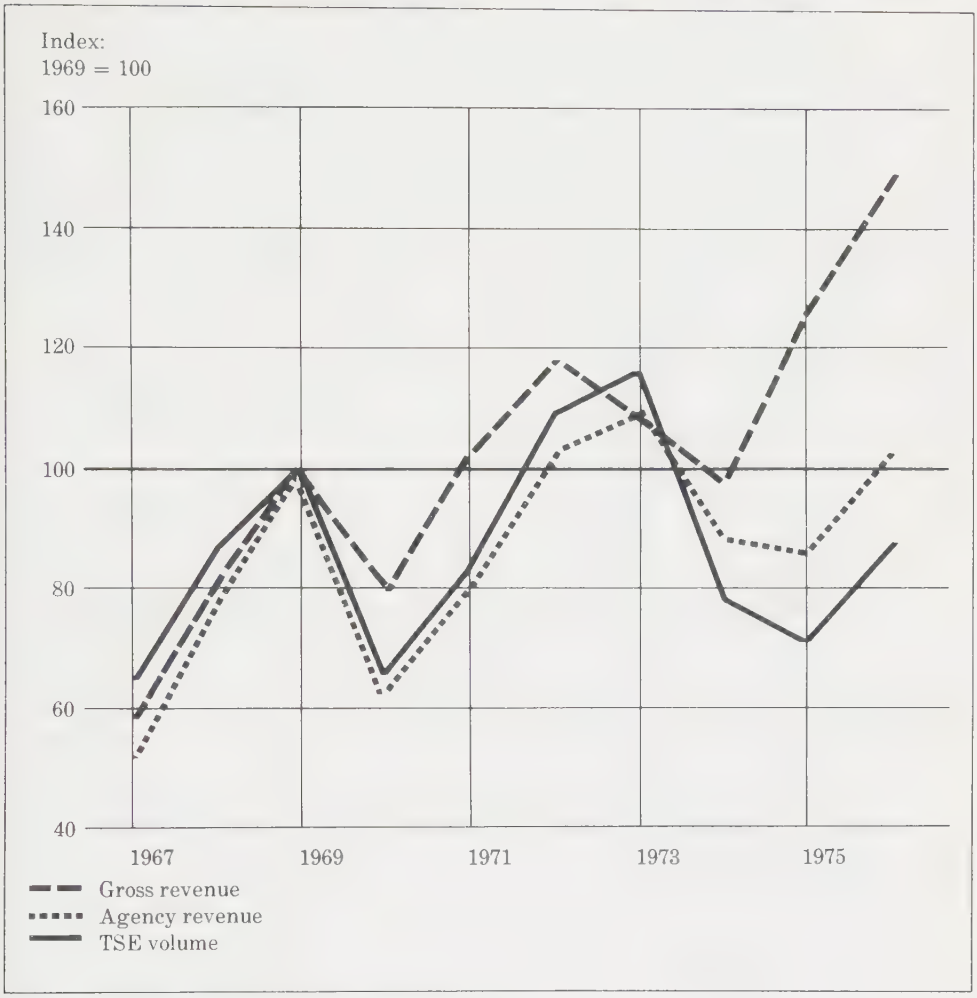
Table 52
Rate of Return on Capital of 12 Toronto Stock Exchange Firms

1967–76 and 1976

	1976	Average 1967–76
5 diversified firms	17.0%	17.1%
2 small institutional firms	6.0	10.4
5 retail and national retail firms	(1.0)	6.4

Source: *Clarkson Gordon Cost Study*, schedules 8, 9, 10, *supra* note 182.

Figure 5
Gross Revenue, Agency Revenue and Volume on the Toronto Stock Exchange, 1967–77



Source: *Clarkson Gordon Cost Study, supra* note 182.

tions. The thirteen firms whose data are represented handled 30.5% of the value of TSE trading in 1976.

The substantial differences among the categories of firm in average cost and average profitability suggest significant differences among the products offered. Bearing in mind that for the thirteen firms commission revenue was only 39.4% of total revenue in 1976, we can easily surmise that joint products and joint costs may differ greatly among the firms. (This percentage is low even for diversified firms. See table 18.) So for decision-making purposes – whether management decisions within firms or rate structure decisions by the commission – the data in table 51 are probably not very helpful.

The study traces total revenue and commission revenue for the sample of thirteen firms over a decade. Figure 5 shows the close correlation between exchange volume and commission revenue. (The commission rate structure was modified in 1973 and a 10% surcharge was in effect for 1975.) The study furnished data on rates of return for the total business (including commission business) of the diversified, retail and institutional firms. These do not tell us much about the commission business except to suggest that despite the costs of non-price competition, the institutional firms have been more profitable than the retail firms and probably this difference reflects the commission rate structure. Table 52 summarizes some comparisons of the study.

On June 30, 1977, the Ontario Securities Commission accepted the TSE proposed rate schedule (after the exchange modified it to restore the $500,000 level at which rates become negotiable rather than moving to $1 million) to be effective September 1, 1977, and to continue for two years. The OSC had the benefit of its own staff position paper, which had estimated rates of return for different segments of the industry under the proposed schedule. It concluded that the rates would not produce unreasonable profits, at least from agency business, and approved them for a two-year period.[185]

The Quebec Securities Commission, which had already given notice of a preference for competitive rates and of its intention to ask for legislation to make rates competitive,[186] tacitly agreed to go along with the Ontario decision, as did the Vancouver exchange.

185 *In re* the Securities Act and Part XV of the By-Laws of The Toronto Stock Exchange, [1977] OSC Bull. 157 (July).

186 8 QSC Bull., No. 16 (April 26, 1977).

2. *The Ontario Securities Commission Staff Position Paper, 1977*

The third of the three careful analyses of revenues and costs in the Canadian industry was the Ontario Securities Commission staff position paper[187] prepared for the commission in the summer of 1977 during proceedings on the TSE proposal for a new set of rates. The author of the paper was Calvin Potter and its conclusions are significant not simply in terms of a particular rate structure (one that was approved by the OSC) but in terms of the whole logic behind rate structures – the purposes they are to serve and the means to achieve those purposes. It seems all too clear that throughout the 1976 and 1977 deliberations the industry and the commission had no very clear set of purposes in mind but were guided by a vague objective of "fair and reasonable" rates, subject to fear of the effects of competition.

Potter points out early in his paper the unsatisfactory nature of a "fair and reasonable" standard without much more specific tests.[188] In effect, the OSC was taking a few faltering steps toward a public utility rate regulation standard. But the standards for this kind of regulation go far beyond "fair and reasonable". They go to cost of capital of the regulated institution and determination of a reasonable rate of return. The commission was unwilling to take this step, yet it agreed with the principle of fixed rates, subject to its approval.

It is interesting that, as Potter noted, the TSE implicitly endorsed competitive commission rates as "fair and reasonable", since its justification for the new fixed rates on both large and small trades was that these rates were comparable to or lower than the competitively established New York rates.[189] In fact, what the TSE had done in large part was to construct a set of fixed rates that roughly matched the New York rates. Potter observed that if the match were a close one, he would have to conclude as an economist that the result was bound to be "fair and reasonable" since it simply duplicated the effects of free competition.

But the match was not perfect and the TSE rates presented two major difficulties. First, as the exchange conceded, since its rates were to be fixed while the New York rates were not, even though the two sets of rates were close, those firms dealing in the New York market would have some flexibility to underprice the Toronto competition. Second, as Potter pointed out, in trying to meet New York competition and at the same time keep revenues

187 Ontario Securities Commission, Toronto Stock Exchange Commission Rate Schedule Hearing, staff position paper (June 7, 1977) (prepared by C.C. Potter).

188 *Id.* at 5 (summary).

189 *Id.* at 5–7.

as high as possible the exchange had come up with a structure that was internally inconsistent.

The exchange had said that there is a substantial fixed cost associated with a trade (although it offered no evidence on this because the Clarkson Gordon study furnished none). This conclusion is undoubtedly correct. The exchange also said that "it does not cost substantially more to trade high-priced shares than low-priced ones".[190] This conclusion is almost certainly correct as well, although there are no data available to prove the point. But the new rate structure follows these principles only for large transactions where NYSE competition is most significant. It does not follow them for small transactions.

Consider the commission on a $60,000 trade compared to the commission on a $40,000 trade. Both are essentially large "institutional" trades. The commission on the $40,000 trade should have covered the fixed costs and so the extra commission in moving to a $60,000 trade should reflect only the extra, or marginal cost, of handling more shares. And if it costs no more to handle 100 shares of a $40 stock than it does to handle 100 shares of a $20 stock, the extra commission should be strictly a function of the number of shares required to bring the trade from $40,000 to $60,000. This is in fact exactly the case. The extra commission is 10¢ per share, regardless of share price, if the price is at least $10. In fact, as the description of the rate schedule easily shows, once a trade exceeds $40,000, the commission for every extra round lot is $10 for any share price above $10.

But for small trades the relationship is very different. Consider the extra commission in going from a $10,000 trade to a $20,000 trade. For a $10 stock the extra charge is 22.5¢ per share. For a $20 stock it is 36¢ per share. And for a $40 stock it is 56.8¢ per share. Potter pointed out that this pricing is not consistent with the exchange's own statement about costs and imposes a discrimination against individual trading of high-priced, "quality" stocks. This discrimination is particularly surprising, since the exchange itself had expressed fears that competitive rates would favour institutions. We seem to have found a fixed rate structure that emphatically favours institutions just in terms of the extra commission charged for each extra round lot traded!

There is a third defect in the new set of Toronto rates. They fail to reflect differences in the kinds of brokerage services offered by different firms and the kinds of services wanted by different customers. We have already seen the emergence of discount bro-

190 TSE, Submission to the OSC regarding the Proposed Commission Rate Schedule, *supra* note 181, at 27.

kers in New York offering a no-frills, execution-only service to individuals many of whom may prefer to obtain their investment advice from a commercial adviser. These low-rate firms exist side-by-side with the long-established retail wire houses that charge significantly higher rates and offer the traditional line of services. The TSE rates were claimed to be below the U.S. wire house rates on individual trades but although the TSE was well aware of the discounted rates, it did not expect that Canadian brokers would meet them.[191] The investor in the Toronto market, then, is simply not given the choice of buying only executions from a broker at a low rate and obtaining investment advice elsewhere.

But quite apart from execution-only service is the matter of accommodation to the variety of services already offered. The exchange itself refers to this variety[192] but makes only limited provision in the rate structure for variations in commissions to accompany variations in service. Instead, brokers are left to adapt service to fit price, something that has long been an unattractive feature of the institutional market; it continues in the individual market in Toronto. Since the extra commission per round lot rises steeply with share price, brokers will find it profitable to encourage individuals to trade in high-priced stocks. Probably the encouragement will take the form of a research emphasis on these stocks, precisely the opposite to the emphasis the TSE has said is needed by the economy.

The staff position paper drew some important conclusions on the profitability of brokerage and "other" activities of member firms. The TSE had said that brokerage was not sufficiently profitable and that retail firms, in particular, needed higher rates. What Potter found was that for the industry as a whole (represented by forty-four firms) brokerage was marginally unprofitable and "other business" was profitable. That is, the marginal cost of increasing brokerage revenue was greater than the revenue itself, while the marginal cost of increased other business was lower than the increased revenue. But for the nondiversified firms, those doing a primarily commission business, the opposite was true for both institutional and retail firms. This conclusion did not prove the firms were profitable, since the analysis did not incorporate fixed costs. But it showed that for these firms commission business at a sufficiently high volume was profitable.[193] It seemed quite possible that the supply of brokerage services was simply too large for the demand – that the industry was too large

191 *Id.* at 33-34.
192 *Id.*
193 *Id.* at 47-55.

to be profitable. This conclusion for the U.S. industry was suggested above.[194]

F. CONCLUSIONS AND POLICY IMPLICATIONS

A fundamental policy issue, of course, is whether commission rates are to be fixed or competitively determined. The United States experience can only lend support to competitive rates but one may argue that something can still go wrong.

Fixed rates that duplicate competitive rates – rates established in a comparable market that does allow competition – will have almost the same effect as competitive rates and are almost automatically "fair and reasonable". But since these rates cannot reflect all possible kinds and levels of services, they deny to both broker and customer the opportunity to match rates and services that exist in a free market. The new (1977) TSE rates do differentiate between low-value and high-value trades and between speculative and investment quality stocks. But even these differentiations can have perverse results. We have seen that small transactions in investment quality stocks have been made expensive for customers and therefore profitable for brokers. The fixed rates also penalize the Canadian industry relative to the U.S. industry, since firms in a competitive market can always cut rates, or "repackage" services and rates to attract business.

If the fixed rates do not duplicate competitive rates, then the regulatory commission will have to assume the powers and responsibilities of a public utility rate regulator – something neither the SEC nor the OSC has ever wanted to do. This kind of regulation calls for a set of standards, almost inevitably involving cost of capital or the "appropriate" rate of return for a brokerage firm. And this in turn calls for cost and revenue allocations that go far beyond anything that the OSC has demanded or that the TSE has provided.

It is difficult to achieve even a fixed and variable cost allocation, although the TSE studies used to do just that. But as Potter has pointed out, the real difficulties arise because of joint costs. The same expenses support both underwriting and commission business. And revenues may be joint too. Success in underwriting may call for a substantial retail operation. Together, the two activities may be profitable. Taken separately, one may appear profitable and the other unprofitable, but this is of no particular importance to the firm which undertakes both together.

We still do not have the cost studies that could demonstrate

194 In the quotation in text accompanying note 143 *supra*.

whether price-fixing is justified and if so, what the appropriate rates would be. The case for destructive competition has not been proven, although the data may exist that would prove it. The TSE suggests that with variable rates the large firms would drive out the small. Potter's analysis, on the other hand, indicates that for the large, diversified firms brokerage is marginally unprofitable, while for the smaller commission-oriented firm it is marginally profitable.

The TSE actually has and collects on a regular basis a substantial amount of cost and revenue data. It should be possible to analyze these data to establish, first, whether rates should be fixed or competitive. If they are to remain fixed, then it should be possible to monitor the industry to see that the fixed rates are kept appropriate. If they are to become competitive, it should be possible to monitor the industry to see that competition is, indeed, working.

But there are further reasons for collecting and analyzing data. So long as self-regulation is considered an important part of a regulatory scheme, the adequacy of incentives and capability for self-regulation is worth continued study. Adequacy of capital in the securities industry and access to capital beyond the resources of employees is a matter of concern at present and calls for continuing economic analysis. The extent to which foreign competition should be encouraged or discouraged, the importance of centralizing trading in a single marketplace, the choice between agency trading and principal trading, and the value of individual trading as opposed to institutional trading all involve policy choices that a regulatory commission will have to deal with sooner or later and all require economic analysis of the brokerage business.

Experience in the United States may be useful here as a guide to what to avoid, as well as to what to do. The SEC has undertaken an enormous amount of data gathering, far more than has ever been attempted in Canada where the work has been left to self-regulatory organizations whose tendency is to keep data highly confidential and who, understandably, prefer to use the data in their own best interests. However, relatively little economic analysis has emerged from the SEC and some testimony given in early 1977 suggested that the agency was completely overwhelmed by data. The moral is that without a clear idea of what is to be done with the data, its collection may be an expensive and unproductive exercise.

From the analysis that has been done it seems almost inevitable that Canadian commission rates will become competitive or substantially competitive. Just how the change is brought about may be important to the securities industry and the capital mar-

ket. The diversified firms have the least to fear because most of their business is other than commission business and this other business appears to be quite profitable. If the firms that are not diversified have a cost advantage, as Potter suggests they have, and if they believe they have this advantage, then they have every reason to continue specializing, realizing that competition may become more intense but that they are in the best position to compete.

If, on the other hand, the nondiversified firms believe they are threatened by diversified firms, they may seek diversification. To do so is not necessarily sound, since the diversification event itself – the entry into new fields – may be very expensive. Many U.S. firms seem to be caught in the same dilemma. The largest have chosen the fully diversified route and are using mergers as probably the least risky and least expensive method to achieve it. The smaller firms (the major regional firms, for example) are looking for ways to remain somewhat specialized and profitable.

Which way firms in the industry move and whether their moves are in their own best interests and the best interests of the industry and the market may depend on the signals given by regulatory commissions.

Chapter IV
Securities-Related Activities of Banks and Trust Companies

There are significant parallels between the debates in the United States – in Congress, the courts and the marketplace – over the appropriate role of banks in securities markets, and the debates taking place in Canada largely involved in the decennial revision of the Bank Act but also as a part of the whole process of regulation of securities markets. The U.S. debate is informative so far as Canada is concerned, partly because of obvious similarities between American and Canadian financial institutions and securities markets and partly because American practices frequently find their way into Canada. In addition, a fair amount of research has been done in the United States and the results can be useful for Canadian planning purposes. Further, some policies and practices that have been proposed for Canada have already been tried out in the United States, and it may be possible to draw some conclusions as to their probable effects in a Canadian setting.

Competition between the banking and brokerage industry in Canada and in the United States has so far consisted almost entirely of banks engaging in activities traditionally associated with investment banking or brokerage. But in June 1977 Merrill Lynch (in the United States) announced a plan that appeared to be

the first venture by a brokerage firm into deposit taking. Merrill Lynch would offer customers automatic investment of their cash balances in a money-market mutual fund with daily interest. At the same time customers would be able to use these balances through VISA cards and cheques on the City National Bank & Trust of Columbus, Ohio. Since the interest rate charged by Merrill Lynch on securities loans was to be lower than rates charged on usual credit card borrowing, the plan offered significant competition to bank-sponsored credit cards.

The competition between commercial banking and investment banking has also become more intense in the United Kingdom, although it is difficult to document just what has happened. The commercial banks – "clearing banks" in British terms – seem to be replacing the investment banking firms – "merchant banks" or "accepting banks" – in underwriting syndicates in both the British domestic market and the Euro-currency market.

The following discussion deals with a number of activities of banks and trust companies in the securities markets including what they do, what they are forbidden to do, what they would like to do, and what others would like them to cease doing. Canadian banks and trust companies are discussed first, followed by American banks. Since banks in the United States are permitted to conduct a trust business, while Canada has separated commercial lending from trust activities giving the first to the chartered banks and the second to the trust companies, we must compare American banks to both Canadian banks and trust companies.

In recent years commercial banks in the United States have found a number of profitable ways in which to expand their securities-related activities. Already equipped with substantial money management facilities in their trust departments, they have looked for ways in which to reach a wider clientele for these services. Their extensive data processing facilities have suggested an opportunity to serve small investors through such things as dividend reinvestment plans that are simply not available from securities firms.

Before turning to the detailed activities of the banks, it may be worth reviewing the attitudes of some of the regulatory authorities with respect to this expansion of bank activities. Jeffrey M. Bucher, a member of the Board of Governors of the Federal Reserve System, testified in December 1975 before Senator Harrison Williams' Subcommittee on Securities. He said:

> "As a general matter, the Board believes that, within limits, commercial banks in securities-related activities can play a constructive role in serving the public, strengthening competitive forces, helping to enhance

> individual participation in capital markets, and insuring efficiency in the allocation of investible funds. At the same time, the need for adequate safeguards for the public and the banks must be given appropriate attention. Each securities-related activity will tend to raise issues of its own, but an overview of the nature of the benefits and risks of the services will help provide a perspective of the Board's position on bank involvement in new service areas."[195]

Bucher described a number of public benefits from the offering of securities-related services by banks. First, banks are already offering a number of services not readily available elsewhere, such as automatic investment plans and dividend reinvestment plans, beneficial chiefly to small investors and generally not available from brokerage firms because of the high cost. The banks through their data processing facilities are able to achieve substantial economies in handling these transactions. Bank services have also drawn new investors into the equity markets which should be helpful in providing necessary equity financing to industry. (Charles W. Buek, president of U.S. Trust Co., also appeared before the subcommittee and stressed the importance of bank data processing equipment in making services available.)[196]

Bucher identified three risks related to bank participation in securities-related activities. The principal one involves the potential for conflicts of interest, but he suggested that bank examiners should be able to take care of this. A second is the potential exposure of bank capital, something that will inevitably accompany any extension of securities underwriting by banks. A third risk concerns the possible concentration of securities activities in banks and ultimate reduction of competition. Bucher was doubtful that this risk posed a real danger.

Specifically, he said the board believed that dividend reinvestment services and automatic investment services are appropriate activities for commercial banks. The board also believes that the potential benefits of investment advisory services outweigh foreseeable risks. However, he commented that the board had not yet reached a judgment as to whether to recommend amendment of the Glass-Steagall Act to permit commingled managed agency accounts, an activity now forbidden to commercial banks by a Supreme Court interpretation of the act.[197] The board is also

195 *Securities Activities of Commercial Banks: Hearings before Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 94th Cong., 1st Sess. 5 (December 9 and 10, 1975).

196 *Id.* at 332.

197 Discussed in the text accompanying note 318, *infra*.

apparently satisfied to have banks or affiliates of bank holding companies serve as advisers to real estate investment trusts and closed-end investment companies. Bucher noted that the board has since 1967 supported a change in legislation to permit commercial banks to underwrite municipal revenue bonds. But he said that the board would not reaffirm its position on this subject until it had reviewed recent developments in the municipal securities markets.

Edwin H. Yeo, testifying before the same committee on behalf of the Department of the Treasury, expressed a general approval from the Treasury for the securities activities of commercial banks.[198] He said that appropriate legislation and supervision by bank authorities should take care of conflicts of interest in money management, and he concluded that agency and brokerage-oriented services would benefit investors and capital markets by providing convenient, low-cost services to investors and encouraging greater participation by small individual investors in securities markets. He did, however, express some concern about the possibility of concentration of investment in a few favoured stocks.

Roderick M. Hills, then chairman of the Securities and Exchange Commission, restated the advantages and risks that had already been discussed by the previous two witnesses[199] and suggested a further risk, that banks might be able to tie securities services to banking services, something that competing securities firms would be unable to do. By and large, Hills did not support or oppose the securities-related activities of commercial banks; he indicated that the SEC was studying their potential.

James E. Smith, Comptroller of the Currency, also testified before the Senate committee. He not only was enthusiastic about the present securities-related activities of commercial banks but supported two specific changes in legislation, to permit banks to offer commingled agency accounts and to permit them to underwrite revenue bonds.[200]

As one might perhaps expect, the bank regulators are generally enthusiastic about expansion of banks into profitable activi-

198 *Securities Activities of Commercial Banks*, *supra* note 195, at 16–21.

199 *Id.* at 88–168.

200 *Id.* at 168. According to the Investment Company Institute, the growth of bank securities and money management activities has been particularly rapid since Congress transferred regulation of fiduciary activities of national banks from the Federal Reserve Board to the Comptroller of the Currency in 1962; *id.* at 307. *See also Financial Institutions and the Nation's Economy (FINE) "Discussion Principles": Hearings before the Subcomm. on Financial Institutions Supervision, Regulation and Insurance of the House Comm. on Banking, Currency and Housing*, 94th Cong., 1st and 2d Sess., pt. 3, at 2436–38 (December 1975 and January 1976).

ties, while the SEC is concerned about the survival of the securities industry.

A. TRUST ACTIVITIES

1. *Canada*

There is a strong tradition in Canada against permitting any single institution to offer trustee services and simultaneously engage in commercial lending. The chartered banks engage in commercial lending but are not permitted to operate trust departments. The trust companies are not permitted to engage in commercial lending, although the chartered banks have complained that some trust company commercial lending is going on.[201] The reason for the separation of activities is essentially the threat of a potential conflict of interest between an institution that on the one hand is lending money to a business and on the other hand is in a position to invest funds in that business. Commercial loans might be made to unsound corporations to support the market for their securities or trust assets might be invested so as to protect the loans. The 1976 federal government *White Paper*,[202] the banks and trust companies, and the Economic Council of Canada[203] have all endorsed the principle and recommended continued separation of the two functions. The president of one trust company, however, has suggested that the conflict problem could be resolved and trust companies allowed to enter banking.[204]

There is little information available on the details of trust activities within the trust companies. The Economic Council of Canada commented that "few statistical data are available on the fiduciary operations of trust companies".[205] The report of the Registrar of Loan and Trust Corporations for the province of Ontario shows that the thirty-eight reporting trust companies were administering a little over $32 billion in assets at the end of 1975.[206] And a breakdown of this total by cash, bonds, stocks, mortgages, guaranteed fund deposits, and real estate is available

201 Canadian Bankers' Association, Bank Act 77, The Industry's Brief 15 (No. 2 1975).

202 Honourable Donald S. MacDonald, Minister of Finance, White Paper on the Revision of Canadian Banking Legislation, Proposals Issued on Behalf of the Government of Canada 29 (August 1976).

203 Economic Council of Canada, Efficiency and Regulation, A Study of Deposit Institutions 79-81 (1976).

204 Comments by Eric J. Brown, Q.C., President of Canada Permanent Trust Co., to the *Winnipeg Society of Financial Analysts* (October 27, 1976), on the White Paper on the Revision of Canadian Banking Legislation.

205 Economic Council of Canada, *supra* note 203, at 20.

206 Report of the Registrar of Loan and Trust Corporations for the Province of Ontario 95-96 (1975). This subject is discussed in more detail in ch. I *supra*.

for the aggregate of the thirty-eight companies and for each of them. No information is available, however, on specific holdings in trust accounts and it is not possible to draw any conclusions on the extent of control or potential control over Canadian industry. This lack of information has been of great concern in the United States, as we shall see, and has led to quite detailed reporting requirements in recent years. W. Grover and J. Baillie, in their paper in this volume, suggest that similar requirements may be appropriate in Canada.[207]

In the course of submissions to the Ontario Securities Commission in 1976 on the subject of fixed commission rates much was made of the concentration of stock ownership in the trust holdings of a few trust companies. This subject is discussed in chapter V.[208] It appears that the percentage of common stocks owned through trust companies in Canada is not very different from the percentage owned by commercial bank trust departments in the United States. Trust ownership in the United States, however, is spread over something like 1,500 commercial banks with one or two hundred holding a substantial portion of the total assets. In Canada the ownership is spread over fewer than fifty trust companies with a half-dozen managing about 90% of total trust assets.

Trust companies are exempt from registration as investment advisers in Ontario,[209] and the exemption would continue in the new legislation contained in Ontario Bill 30,[210] although Bill 30 would require a trust company to register as a management company in order to manage a mutual fund for compensation under a contract.[211]

Trust companies are "exempt" purchasers of securities, and the issuer of securities sold exclusively to exempt purchasers need not register under the Ontario Securities Act and no prospectus is required. Furthermore, trust companies are "exempt" purchasers even when purchasing on behalf of trust accounts.[212] The implication of this specific statutory provision is that other financial institutions do not qualify a purchase as exempt when they are buying for a managed account, and Grover and Baillie suggest that other institutions should have the same opportunity. [213] The

207 *Grover & Baillie* at n. 318.

208 In text accompanying note 460 and following.

209 Ontario Securities Act, s. 18(a). In any case, the definition of "advising" probably does not cover the management of trust accounts. The other provinces grant the same exemption.

210 Ontario Bill 30, s. 33(a).

211 Ontario Bill 30, s. 24(I)(e).

212 Ontario Securities Act, s. 58(1a) says that a trust company is "deemed to be acting as principal when it trades as trustee for accounts fully managed by it".

213 *Grover & Baillie*, text following n. 362.

trust companies may have an advantage over investment counsel under the Ontario Act, since a substantial amount of new issue financing is done by way of the exempt purchaser route. (A second advantage, so long as broker commission rates are fixed, lies in the ability of trust companies but not investment counsel to pool purchases for several accounts in order to take advantage of reduced commission rates.)[214] Professor L. Loss, in his notes to the American Law Institute's draft Federal Securities Code, says of an exemption for purchases by "institutional investors":

> "It is implicit...that banks and insurance companies are institutional investors whether buying for their own accounts or for accounts under their investment managements. This would have been made explicit, except that it might have created a negative implication with respect to the clients of certain investment advisers. Obviously it would not be realistic to treat all clients of all investment advisers as institutional investors...it is contemplated that rules...will make appropriate distinctions among investment advisers, and will not discriminate, so far as clients are concerned, between banks and insurance companies on the one hand and those investment advisers that deserve similar treatment on the other hand."[215]

Ontario Bill 30 does not alter the exemption for purchases by trust companies on behalf of trust accounts[216] but it does alter the ability of a trust company to dispose of securities acquired in an exempt purchase. Under the present Ontario Securities Act, no formalities accompany such a resale (although the trust company must have purchased the securities originally "for investment only and not with a view to resale or distribution" which implies some restraints on turnover), because a prospectus is required only for a "distribution to the public",[217] and distribution to the public is defined to include sales by controlling shareholders and sales to the public of securities "not previously distributed to the public".[218] The Ontario Securities Commission has taken the position that securities acquired by an institution in an exempt purchase have been distributed to the public (the institution being part of the "public") and therefore the trust company (unless it happens to be a controlling shareholder or could be considered to be an underwriter) is free to resell without a prospectus.[219]

214 Commission rates are discussed in ch. III *supra*.
215 ALI Federal Securities Code, Tent. Draft No. 1, at 29-30.
216 Ontario Bill 30, s. 73(2).
217 Ontario Securities Act, s. 35.
218 *Id.* s. 1(1)6b.
219 *Grover & Baillie* at n. 288. Baillie has argued that this interpretation is wrong.

But Bill 30 puts some limits on resales. The issuer of the securities will have to be a "reporting issuer", the trust company will have to have held the securities for six, twelve, or eighteen months depending on whether they are legal for life insurance companies or listed stocks, and a report must be filed with the commission.[220] This limitation may introduce some difficulty in terms of a tradeoff between the opportunities for trust accounts in exempt purchases and the "lock-in" or expense of a prospectus on resale.

Grover and Baillie point out the "all or nothing" resale provisions of Bill 30 mean that the trust company may sell its entire holding free of a prospectus if it meets the conditions described above but not one share if it does not. They recommend the same "trading transaction exemption" they would give issuers for a small volume of resales with the full prospectus requirement for large sales.[221] But a trust company, having decided that an issue is no longer appropriate for some accounts, may well decide it is inappropriate for any, and want to sell out completely. And there may be unfair treatment of accounts vis-à-vis one another at the time of sale, if only a small portion of total holdings may be sold. The Bill 30 proposal is somewhat similar to proposals in the United States for limitations on sales by institutions, and raises some of the same objections.[222]

2. *United States*

The Comptroller of the Currency reported to Senator Lee Metcalf's subcommittee in 1974 that of the 4,600 national banks in the country, 1,900 were authorized to exercise trust powers and 1,600 actually exercised them. There are at least 300 commercial bank trust departments managing assets of $100 million or more.[223] In 1975 United States commercial banks managed approximately $400 billion in trust assets,[224] 41% of them in employee trust and agency accounts.[225]

220 Ontario Bill 30, s. 73(4).

221 *Grover & Baillie* at nn. 343, 377.

222 *See* ch. V *infra*.

223 *Corporate Disclosure: Hearings before Subcomm. on Budgeting Management and Expenditures of the Senate Comm. on Government Operations*, 93d Cong., 2d Sess. 56, pt. 3 (June and August 1974); Federal Deposit Insurance Corporation, Trust Assets of Insured Commercial Banks - 1974 (1975). The FINE discussion principles proposed extending trust powers to savings and loan associations, credit unions and mutual savings banks; *see* House Comm. on Banking, Currency and Housing, 94th Cong., 2d Sess., 1 FINE: Financial Institutions and the Nation's Economy 9 (1976) (compendium of papers).

224 Federal Deposit Insurance Corporation, Trust Assets of Insured Commercial Banks - 1975, table I (1976).

225 SEC, Final Report on Bank Trust Activities 125 (July 1977).

As already noted, Canada has taken the position that there is an inherent conflict of interest if one financial institution carries on both a commercial lending and a trust business. There is an awareness of this conflict in the United States and there has been a good deal of testimony on the subject before congressional committees in recent years.

The *Hunt Commission Report*, in dealing with bank trust departments, recommended that there be a "wall" between the commercial banking and trust departments of banks with trust assets over $200 million, that brokerage commissions not be used to attract deposit or loan business, that inside information not be used in the trust department, and that banks establish procedures to review the uninvested cash in trust accounts.[226] The Comptroller of the Currency has been sufficiently sensitive to the issue to insist that the commercial banks set up some sort of system to ensure that commercial lending departments do not communicate with trust departments and the result has been what some bankers call a "Chinese wall" between commercial lending and trust activities, and the comptroller has proposed explicit regulations to prohibit the use of inside information in making investment decisions for trust accounts.

There are those who are not satisfied by the comptroller's action or by the apparent responses of the banks, and who argue that commercial lending and trust activities should be separated as they are in Canada.[227] But there does not seem to be very much support for this position and there certainly seems to be no disposition on the part of Congress to dismember commercial banks, although there are proposals before Congress to give trust powers to other institutions.

An interesting discussion of conflicts in trust departments appears in the record of congressional hearings on financial institutions in December 1975. Professor Edward S. Herman, who had prepared a study on the subject for the Twentieth Century Fund, observed that abuse of inside information is not the principal difficulty and indeed in their efforts not to use inside information trust departments may be failing to use public information and therefore failing to do their best for trust accounts. (Apparently

226 Report of the President's Commission on Financial Structure and Regulation (December 1971) [hereinafter Hunt Commission Report].

227 A former member of the Federal Reserve Board has suggested that some banks might find it advantageous to separate the two activities into two institutions; *Securities Activities of Commercial Banks: Hearings before Subcomm. on Securities*, *supra* note 195, at 9.

sales of Penn Central stock as the company was failing were unfortunately inhibited.)[228] The more important conflicts involve the use of trust cash balances and unequal treatment of trust accounts. Herman also argued that bank regulatory authorities were much more concerned with depositor protection than with the protection of trust clients.[229]

It is interesting that some congressional committees in asking bank trust departments about commercial lending to companies whose stocks are held in trust accounts have perhaps unintentionally brought about breaches in the "wall". Indeed, some bank trust departments declined to respond to a congressional questionnaire for just this reason.[230] At the same time, it is hard to understand how a bank trust department could do a thorough security analysis of a company and not discover that the bank's commercial department was a major lender to the company. Some trust departments simply steer clear of companies for which their bank is a major lender, and some simply avoid stock interests in any but the soundest companies.

Another area of conflict has to do with the use of brokerage commissions, paid ultimately by the beneficiaries of trusts, to purchase services that may be of considerable benefit to the bank trust department. Until brokerage commission rates became competitive on May 1, 1975, the issue was somewhat academic. Bank trust departments were generally unable to obtain executions for less than the fixed minimum commissions (although there were some opportunities to do so in the so-called "third market"), so that

228 It would be interesting to know what bank trust departments were doing with New York City bonds in 1974 and 1975. One report suggests the banks were selling the bonds out of *their own* portfolios on the basis of inside information; *see* New York State Assembly Office of Legislative Oversight, The Bank and the Municipal Crisis: Public Responsibility and Private Profit (November 15, 1976). The SEC confirmed this suggestion in August 1977, but at least one bank claimed the SEC was wrong; *see* Subcomm. on Economic Stabilization of the House Comm. on Banking, Finance and Urban Affairs, 95th Cong., 1st Sess., SEC Staff Report on Transactions in Securities of the City of New York (Comm. Print 1977); and *see e.g.* Morgan Guaranty Trust Co., *Morgan Guaranty Trust Reports on "Transactions in Securities of the City of New York"*, The Wall Street Journal, September 12, 1977, at 9, col. 1 (advertisement).

229 *Financial Institutions, Hearings before Subcomm. on Financial Institutions, supra* note 200, pt. 1, at 329-35 (December 1975). *And see* E. Herman, Conflicts of Interest: Commercial Bank Trust Departments (the Twentieth Century Fund 1975).

230 Subcomm. on Financial Markets, Senate Comm. on Finance, 94th Cong., 2d Sess., Bank Trust Stock Holdings: Responses to Financial Markets Subcommittee Questionnaire (June 1976). It was reported in 1975 that most banks prohibit disclosure of broker deposits to trust departments or traders, so that choice of broker cannot be a function of deposits. *See* Stanford Research Institute for the Trustees of the Banking Research Fund, Association of Reserve Bankers, The Trust Activities of the Banking Industry 11, 50 (1975).

if commissions purchased not only the executions required by the trust accounts but also research services that were of value to the trust department itself, the beneficiaries could hardly complain. But with the unfixing of commission rates it is not quite so clear that bank trust departments are entitled to use commissions paid by the trusts to purchase research services. Congress anticipated the problem, and included in the Securities Reform Act of 1975 a new section 28(e) of the Securities Exchange Act of 1934, which provides:

> "No person...in the exercise of investment discretion with respect to an account shall be deemed to have acted unlawfully or to have breached a fiduciary duty under State or Federal Law unless expressly provided to the contrary by a law...solely by reason of his having caused the account to pay a member of an exchange, broker, or dealer an amount of commission for effecting a securities transaction in excess of the amount of commission another member of an exchange, broker, or dealer would have charged for effecting that transaction, if such person determined in good faith that such amount of commission was reasonable in relation to the value of the brokerage and research services provided...viewed in terms of either that particular transaction or his over-all responsibilities with respect to the accounts as to which he exercises investment discretion."

This section authorizes what is known as "paying up", that is, paying more than the minimum going rate for transaction services alone, in order to obtain further services, generally research services. The conflict of interest issue arises because the bank trust department already has an obligation to provide management for trust accounts and the research necessary for this management might well be regarded as the responsibility of the trust department paid for by trust department fees charged to the individual trust accounts.

Section 28(e) has been subject to a good deal of criticism. The Securities and Exchange Commission has warned that the section does not authorize "paying up" for services that are generally available for public purchase.[231] And the commission has promulgated proposed regulations calling for the disclosure of broker selection policies and the use of commissions to purchase re-

231 *See* Commissioner J.R. Evans address before the *National Trust Conference, American Bankers Association* (February 7, 1977) ("An SEC Perspective on Bank Trust Departments"). On this topic *see also, Connelly.*

search.[232] Since the SEC does not have jurisdiction over bank trust departments, however, the proposed regulations would not apply to them. The position is that account beneficiaries should know what benefits, if any, they are receiving in addition to executions for the brokerage commissions their accounts are being charged.

Apart from the conflict issue, the chief concern in the United States has been with possibly excessive concentration of corporate control in bank trust departments. The Hunt Commission recommended that banks publish annual reports showing the twenty largest stock holdings, excluding any holdings worth less than $10 million and not constituting 1% of outstanding voting shares of the issuer, reporting holdings that constitute 5% or more of an outstanding registered voting stock issue, dollar values with respect to listed holdings broken down by sole, shared and no voting responsibility, interlocking directors, officers or senior employees and cases in which the bank voted against management or against a management recommendation.[233]

There has been considerable concern in recent years in Congress about the need for fuller disclosure of the ownership and particularly voting power in U.S. corporations. Senator Metcalf, whose subcommittee held extensive hearings on the subject in 1974,[234] has stressed a special need to know who owns and controls regulated corporations. And he has spoken of the dangers of foreign influence on major American corporations including defence contractors. Finally, he has talked of the dangers of economic concentration through institutional control of corporations and industries.

A representative of a large New York bank testifying before Senator Metcalf's subcommittee in 1974 suggested that the disclosure form used by federal agencies in the United States could be substantially improved and that nominees and corporations could be required to provide more useful information.[235] He suggested that ownership reporting would be improved if nominees were required to make it easy for an issuer to identify multiple nominees of a single institutional investor and that corporations in their own reporting should be required to aggregate and treat as one all the various nominee holdings of a single institution. All of this pertains to ownership but not necessarily to voting power. The wit-

232 SEC, Securities Exchange Act of 1934 Release No. 13024, November 30, 1976, [1976-1977 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 80,815.

233 Hunt Commission Report, *supra* note 226.

234 *Corporate Disclosure: Hearings before Senate Subcomm. on Budgeting, Management and Expenditure, supra* note 223, pts. 1, 2, 3 (March 1974, April and May 1974, June and August 1974).

235 *Id.* pt. 1, at 34-117.

ness suggested that separate disclosure of voting power could be required but that some standard definitions would be needed to account for different kinds of voting power possessed by institutions.

Professor David L. Ratner, another witness before Senator Metcalf's subcommittee, stressed the need to have information available in consistent form in a single place.[236] Many kinds of corporations, particularly regulated corporations, already report significant holdings of their shares. But apart from the use of nominees, which makes much of this reporting useless, the fact that they report to different agencies on different forms makes it difficult to pull together ownership patterns. And from the institutional investors' side, bank trust departments did not report anything.

In general, there seemed to be no reporting at all that would indicate the concentration of ownership of *debt* securities in financial institutions. The subcommittee itself had solicited information from twenty-five institutions with assets of $5 billion or more. The Interstate Commerce Commission produced some figures showing that about 25% of the composite debt of the fifteen largest railroads in the United States was held by banks in 1973.[237] The chairman of the Federal Power Commission expressed his regret to the committee that he could not tabulate by lender the major debt holdings in electric utilities and natural gas pipeline companies,[238] and he conceded that bond holders may have a significant influence over management.

A representative of the General Accounting Office reported that his office was reviewing the gathering of information by federal regulatory agencies and had proposed regulations for uniform and more useful data.[239]

The chairman of the Federal Trade Commission testified on a study by the commission's Bureau of Competition of the financial relationship between institutions, particularly banks, and energy corporations.[240] The concern was that the interlock between the institutions and the corporations might lead to an indirect interlock between corporations competing in the energy industry.

A.A. Sommer, a commissioner of the Securities and Exchange Commission, testified on the impact of institutional trading on the securities market.[241] He referred to the proposals of Senator Lloyd

236 *Id.* pt. 1, at 119.
237 *Id.* pt. 2, at 641-59.
238 *Id.* at 733-34.
239 *Id.* at 854-75.
240 *Id.* at 898, 913-28.
241 *Id.* at 943-44.

Bentsen that would restrict the holdings of some institutions,[242] but these comments were incidental to his discussion of the issue that concerned the committee, concentration of ownership and voting power. Sommer discussed the disclosure of ownership that is required by the SEC and the problems the commission had encountered in trying to discover ownership behind nominee names.

The Comptroller of the Currency had recently required for national bank common trust funds and for pooled funds annual reporting of portfolio assets, including identification of equities by issue. Proposed regulations would require annual reporting for trust departments administering assets in excess of $100 million on all trust assets, including identification of equity issuers for all holdings in excess of 10,000 shares. The 10,000-share cutoff corresponds to approximately $500,000 on average. The regulations were still being commented on in August 1974. He reported that the same proposed regulations included provisions requiring all national banks operating trust departments to establish policy procedures designed to assure that trust department investments do not utilize nonpublic financial information.[243]

In anticipation of the hearings data were gathered by the staff of Senator Metcalf's subcommittee on some trust department holdings of large banks.[244] For example, as of 1972 the Chase Manhattan Bank held 2% or more of the stock of forty-six of eighty-nine corporations that had furnished data to the committee. Morgan Guaranty Trust and First National City Bank held 2% or more of the stock in twenty-nine and twenty-eight of the corporations, while Bankers Trust held 2% or more in twenty-one corporations. Holdings in certain industries were more concentrated. The Chase Manhattan Bank trust department held between 9% and 6.9% of the stock in each of four airlines and between 8.3% and 5.3% of the stock in each of six railroads. The combined holdings of several banks were quite substantial. The trust departments of six banks plus one brokerage firm and the New York Stock Exchange Clearing Corporation together held 20% or more of the stock of a number of corporations.

These statistics reflected ownership rather than voting power. It was impossible to translate them into voting power

242 *See, Stockholders Investment Act of 1974: Hearings on S. 2787 and S. 2842 before Subcomm. on Financial Markets of the Senate Comm. on Finance*, 93d Cong., 2d Sess. (February 5 and 6, 1974).

243 *Corporate Disclosure: Hearings before Senate Subcomm. on Budgeting, Management and Expenditure, supra* note 223, pt. 3, at 56–69.

244 Subcomm. on Intergovernmental Relations, and Budgeting, Management and

because the right of a bank trust department to vote shares held by it varied among trust accounts and the right of the stock clearing corporation and of a brokerage to vote shares depends upon client arrangements. For certain industries, including broadcasting corporations, details on voting power held by institutional investors were available because they are collected by the Federal Communications Commission. As of 1972 the ownership of broadcasting companies by the trust departments of large New York City banks ran as high as 14%; eleven banks combined had 38% of the voting rights in Columbia Broadcasting System, Inc. and eight banks held in the aggregate 34% of the voting rights in American Broadcasting Companies Inc.[245]

Some of these statistics apparently gave rise to alarm but none of the testimony demonstrated that harm had actually been done through institutional ownership or voting power. There simply seemed to be a rather vague fear of what trust departments might do.

Fresh statistics on stock holdings of institutions were reported to Senator Metcalf's subcommittee in the spring of 1976.[246] The first part of the report was prepared by Professor Robert M. Soldofsky and was largely based on stock holdings as of the end of 1974 reported by national banks to the Comptroller of the Currency. The comptroller had initiated this reporting as of December 31, 1974,[247] and required classification of all holdings according to whether the bank held full voting rights, partial voting rights or no voting rights. Soldofsky made use of commercially published data on investment company and insurance company stock holdings but was unable to obtain information on pension fund holdings. His report covered common stock holdings by bank trust departments, investment companies, and insurance companies in 146 corporations. For 1974 the New York Stock Exchange estimated institutional holdings in the aggregate at 33% of the value of all listed stocks. For the 146 corporations there was more than 40% institutional ownership in eight cases and 30%

Expenditures of the Senate Comm. on Government Operations, 93d Cong., 2d Sess., Disclosure of Corporate Ownership 6-8 (March 4, 1974).

245 *Id.* at 169-70.

246 Subcomm. on Reports, Accounting and Management of the Senate Comm. on Government Operations, 94th Cong., 2d Sess., Institutional Investors' Common Stock Holdings and Voting Rights (May 1976). Further statistics on the holdings of the 28 largest trust departments were published in Subcomm. on Financial Markets, Bank Trust Stock Holdings: Responses to Financial Markets Subcommittee Questionnaire, *supra* note 230.

247 12 C.F.R. 9.102 (1977) (Annual Report of Equity Securities—Form CC 7510-03). The report requires an annual report of holdings of 10,000 or more shares of any issue of common stock classified by voting rights.

to 40% ownership in twenty-seven cases.[248] Where institutional ownership was high, regulated investment companies generally accounted for at least 50% of this ownership.[249] Bank trust departments held up to 25% of the voting power of a few corporations.[250]

The second part of the report to Senator Metcalf's subcommittee was prepared by the Library of Congress and was based on a survey of sixty-six banks, including custodial, corporate trust and corporate agency accounts. Holdings reported were as of the end of 1974. The banks were those that reported trust assets in excess of $1 billion as of the end of 1973. The chief finding of the report was the great difficulty banks had in responding to requests for specific information. Data were compiled, however, for holdings in trust accounts, custodial accounts, and corporate trust and agency accounts classified by voting rights and some analysis was offered.[251]

One outcome of the hearings in 1974 was a significant change in public reporting requirements. The Securities Reform Act of 1975 added section 13(f) to the Securities Exchange Act of 1934. This new subsection requires reporting by all institutional investment managers (including bank trust departments) exercising discretion over accounts holding stocks aggregating more than $100 million. The SEC is authorized to reduce this value cutoff to as little as $10 million. The SEC may also establish the reporting period which may not be less than one quarter or more than one year. The report must show for each listed stock held at the end of the reporting period the name of the issuer, the class of the stock, the CUSIP identification number, the number of shares held and the aggregate fair market value. The SEC is authorized to require a separate listing of the number of shares held with respect to which the manager possesses sole or shared voting authority, the aggregate purchases and aggregate sales during the reporting period of each security, and rather more substantial disclosure for any transaction or series of transactions having a market value of $500,000 or a lower cutoff value established by the SEC. The SEC estimated that this reporting requirement will apply to about 300 institutions holding approximately 75% of all institutional equity securities.[252]

When the reporting requirement was first proposed in 1974,

248 SUBCOMM. ON REPORTS, ACCOUNTING AND MANAGEMENT, INSTITUTIONAL INVESTORS' COMMON STOCK HOLDINGS AND VOTING RIGHTS, *supra* note 246, at 4.

249 *Id.* at 12-13.

250 *Id.* at 14-15.

251 *Id.* at 418-45.

252 *Institutional Investors Full Disclosure Act: Hearings before Subcomm. on Securities*

the Treasury Department strongly opposed the reporting of institutional transactions. The general counsel to the Treasury said that such reporting would introduce unfairness by placing at a disadvantage investors who use institutions to manage their funds. The Treasury also saw as one purpose for the disclosure the provision of information to the SEC so that the commission could decide whether there should be statutory restrictions on institutional trading. The Treasury Department said it "firmly believes that regulation of institutional trading is unnecessary and also contrary to the public interest". Serious proposals had been made to restrict both the extent of institutional ownership of securities and institutional trading in them.[253]

Despite enthusiasm for disclosure from almost every part of the securities and investment industry and of course from the SEC and Congress, few sensible suggestions were offered as to just how the information might be used. Proposals that trust department clients would be better able to judge which bank to go to were quickly discarded as implausible. There was, however, general agreement that investor "confidence" would be enhanced by the disclosure.

The chairman of the SEC said that he saw two chief reasons for continued study and analysis based on a good flow of data from institutional investors. One was simply the need for a continuous review of securities markets and the second was the need for verifying or disproving claims that institutions are interfering with the proper operation of the markets. He described the kinds of studies that could be made if the disclosure statute were enacted. One category would deal with effects of institutional holdings and trading and would include parallel trading of institutions and related price effects, block trading and market liquidity, competition in the brokerage community, and so on. The second general category would have to do with performance of different investment managers.[254]

Enthusiasm for disclosure was not unanimous. The comments of Dean Miller, Deputy Comptroller of the Currency for Trusts, are interesting:

"I think it should be recognized that the only way we are

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of the Senate Comm. on Banking, Housing, and Urban Affairs, 93d Cong., 2d Sess. 22 (August 13 and 14, 1974).

253 *Institutional Disclosure and Sales of Investment Company Advisers: Hearing on H.R. 10570 and H.R. 13986 before Subcomm. on Commerce and Finance of the House Comm on Interstate and Foreign Commerce*, 94th Cong., 1st Sess. 22-23 (September 13, 1975). The proposals are discussed in ch. V *infra*, in connection with the impact of institutional trading.

254 *Institutional Investors Full Disclosure Act*, *supra* note 252, at 21.

> going to get this man of modest means into the stock market is through the device of the no-load mutual fund – that and indirectly through his pension fund.
> "Our governmental concern should be toward the effectuation of a system which permits as many as possible choices of such funds to him, including some administered by banks. He is not going to invest directly in the stock market more if he knows that there is a massive bin somewhere in this country containing detailed minutia of the investments and transactions of everybody who has more money than he.
> "To be more specific, increased disclosure of bank trust department holdings is going to be of no benefit at all to him. Neither will the implementation of a few more government agencies and a few additional cost burdens upon banks. They will only redound to his detriment."[255]

As of late 1977, at least one congressional subcommittee was impatient not only with the SEC's slowness in implementing the data collection but also with the lack of progress in deciding what to do with it.[256]

Grover and Baillie, who suggest that section 13(f) disclosure might be appropriate in Canada, offer a number of purposes to be served. Probably the best is "to reinforce the public acceptability of existing societal institutions by providing the information to refute charges of unacceptable behaviour".[257] One might add that the data disclosed may require substantial analysis – such as correlating institutional sales and holdings with market behaviour – to establish the refutation.

Banks in the United States, as in Canada, are generally subject to banking laws and not to securities legislation even with respect to securities-related activities. Trust activities of banks are generally exempt from federal securities laws but regulation 9 of the Comptroller of the Currency provides for licensing of trust departments of national banks and deals with bonding, fiduciary records, audits, restrictions on holding trust assets uninvested, prohibitions on self-dealing activities, segregation of assets and public disclosure of trust assets. Regulation 9 permits "crossing" orders for both agency and trust accounts, and requires that the

255 Address of Dean Miller to the *Iowa Trust Association, reprinted in Financial Markets: Hearings before Subcomm. on Financial Markets of the Senate Comm. on Finance*, 93d Cong., 1st Sess., pt. 2, at 125 (September 1973).

256 Report of the Subcomm. on Oversight and Investigations and the Subcomm. on Consumer Protection and Finance, of the House Comm. on Interstate and Foreign Commerce, Oversight of the Functioning and Administration of the Securities Acts Amendments of 1975 15-17 (Comm. Print 1977).

257 *Grover & Baillie*, text following n. 139.

trade be "fair to both accounts".[258] Banks may be found liable under Rule 10b-5 of the Securities Exchange Act of 1934 for misuse of inside information in managing portfolios.[259]

The securities industry says record-keeping and audit requirements under the federal securities laws are stricter.[260] And the SEC says regulation 9 is not as comprehensive or protective of investors as the Investment Company Act.[261] The banks are rather defensive about this. Citibank inaugurated its Investment Management Group annual report in 1970 as a device to insure public disclosure of trust activities. A review by Arthur Young and Company of the bank's policies and procedures was published in the 1975 hearings before Senator Williams' Subcommittee on Securities and dealt with commissions, executions, use of "inside" information, uninvested cash, voting of proxies, allocation of purchases and sales among trust accounts and independence of trust and lending activities.[262] BankAmerica Corporation, the holding company for the Bank of America, the largest U.S. commercial bank, published a voluntary disclosure code in 1976.[263]

The SEC has said that trading personnel in bank trust departments are often ignorant of federal securities laws and that this ignorance leads to recurring violations.[264]

B. BANK UNDERWRITING OF SECURITIES

1. *Canada*

Canadian chartered banks are permitted to "deal in" securities and they have traditionally engaged in some aspects of underwriting. The Bank Act prohibits the naming of a chartered bank in a prospectus for corporate securities[265] perhaps because of a potential conflict of interest between the bank's possible position as a lender to the corporation and its promotion of the corporation's securities or perhaps just because of a fear that *any* reference to a bank inspires too much confidence. A few banks have partici-

258 *See Securities Activities of Commercial Banks: Hearings before Subcomm. on Securities, supra* note 195, at 104–05. The First National Bank of Chicago has said that it does not "cross" trades between fiduciary accounts; *id.* at 122.

259 *Id.* at 107, 152. *Id.* at 157 refers to SEC, THE FINANCIAL COLLAPSE OF THE PENN CENTRAL COMPANY (1972), analyzing sales by three major banks of Penn Central Stock prior to the bankruptcy.

260 *Securities Activities of Commercial Banks: Hearings before Subcomm. on Securities, supra* note 105, at 110.

261 *Id.* at 165.

262 *Id.* at 302.

263 BANKAMERICA CORPORATION, VOLUNTARY DISCLOSURE CODE (November 1976).

264 SEC, FINAL REPORT, *supra* note 225, at 16.

265 Bank Act, s. 157(2).

pated in corporate underwriting banking groups but most banks participating in new issues of corporate securities have acted as agents, only taking orders for the securities. At the same time chartered banks have traditionally participated in the underwriting of new issues of the Government of Canada, provinces, municipalities and some international agencies.

The underwriting function seems to have originated in bank loans to finance investment-dealer underwriting with banks subsequently becoming regular participants in underwritings for all provinces, some municipalities and some corporations. Underwriting in Canada still reflects long-standing relationships among issuers and members of an underwriting group, including bank members, and the investment dealers are somewhat ambivalent about the banks' role. On the one hand, a traditional relationship with an issuer may be strengthened by the presence of a bank in the group. In the case of a municipal issuer, for example, the traditional willingness of the bank to take up the short maturities helps to reduce risk in the underwriting. On the other hand, there is a real fear of the bank as a true competitor rather than an ally and the dealers would be most comfortable with the status quo – no expansion of bank underwriting. The "official" view of the Investment Dealers Association, however, is opposed to the banks underwriting any but Canadian government issues.

It seems probable that the banks have a cost advantage over the investment dealers and brokers in distributing new issues of securities to individuals and quite likely to institutions as well, and probably the capital markets would be best served by allowing them to exploit that advantage. But the securities industry argues that the result would be to squeeze out the brokers and dealers, to lessen competition and in the end to reduce the efficiency of the market. It also argues that banks do not offer sufficient protection and expertise to customers who presumably do not recognize this deficiency or if they do, do not care about it.

The government *White Paper on the Revision of Canadian Banking Legislation* proposed that banks could be named in corporate prospectuses, but would not be permitted to participate in the underwriting of corporate issues.[266] Nor would they be permitted to participate as agents in the arrangement of private placements. The potential conflict of interest referred to above was given as the reason for both of the new rules. However, banks would be explicitly authorized to participate in selling groups for new issues and would be allowed to advertise their participation. The *White*

266 White Paper on the Revision of Canadian Banking Legislation, *supra* note 202, at 34-35.

Paper concluded that these rules would adequately protect investment dealers from the competition of chartered banks but would also give purchasers of corporate securities access to new issues through chartered banks without their having to pay a commission on top of the offering price. The reaction of the securities industry has been enthusiasm for the prohibition on corporate underwriting but protests over the permitted selling group activities.[267]

The *White Paper* proposals would continue chartered bank underwriting of government issues, including issues of provinces, municipalities and some international agencies. The securities industry has urged a ban on provincial and municipal underwriting by chartered banks.[268]

In its report on the government's proposals, the Senate Banking, Trade and Commerce Committee approved putting specific provisions in the act to define permitted securities activities of the chartered banks. But it did not clearly state its preferences for which activities should be permitted and which prohibited. It merely suggested that banks should not be permitted to underwrite corporate securities or to act as agents for private placements and that banks should be allowed to underwrite federal, provincial, municipal, and international agency securities and to distribute corporate securities as members of a selling group.[269]

Until 1966 the Ontario Securities Act (and the acts of six other provinces) provided an exemption from prospectus requirements for securities issues underwritten by banks. In 1966 Ontario eliminated this exemption and a number of provinces have followed.[270] But Grover and Baillie suggest that some financial institutions at least have in effect underwritten public distributions by purchasing by way of an "isolated purchaser" exemption and then reselling to the public so that no prospectus was ever filed.[271]

Although a bank underwriting cannot confer an exemption on an issue not otherwise exempt, the bank itself need not register as an underwriter under the Ontario Securities Act.[272] A member of a selling group (as opposed to a banking group) does not seem to

267 Joint Committee of the Canadian Securities Industry, Memorandum on the Securities-Related Aspects of the White Paper on Canadian Banking Legislation, at 13-15 (October 14, 1976). The industry was particularly alarmed at the prospect of banks distributing securities to institutional investors; *id.* at 14.

268 *Id.* at 10-11.

269 *Standing Senate Comm. on Banking, Trade and Commerce*, *supra* note 2, at 44:12, 44:68.

270 *See* J. Williamson, Supp. at 141-43.

271 *See, Grover & Baillie*, text following n. 286.

272 Ontario Securities Act, s. 6(1)(d).

be an "underwriter" within the meaning of the act[273] but in any case banks and trust companies are not required to register to trade in securities generally.[274] Ontario Bill 30 would narrow the underwriter exemption for banks. "Underwriters" seem to include selling group members, and banks would be exempt from registration only with respect to issues of government or municipal bonds, securities guaranteed by a bank, loan or trust company or insurance company, or securities issued by a trust company pooled fund or common trust fund.[275]

2. *United States*

Section 16 of the Glass-Steagall Act of 1933 prohibits commercial banks in the United States from underwriting securities, except for obligations of the United States and general obligations of any state or political subdivision.[276] This prohibition reflected a very strong policy decision to separate commercial from investment banking. But the exception for general obligation state and municipal bonds is quite important, and there is a substantial amount of bank underwriting of these bonds. What has been of great interest in recent years is the question of whether commercial banks should be permitted to underwrite municipal revenue bonds, which are not backed by the full faith and credit of a state or municipality.

For a variety of reasons, sometimes having to do with general obligation debt limits and sometimes having to do with the tax advantages of municipal bonds, there has been a substantial increase in recent years in the issue of municipal revenue bonds. Representatives of the banking industry have urged that banks should be permitted to underwrite these bonds. And indeed, there are some exceptions in the Glass-Steagall Act to permit bank

273 *Id.* s. 1(1)25.

274 *Id.* s. 19(1)3. The same is true in the other provinces.

275 Ontario Bill 30, ss. 1(1)41(iv) and 35(2)1.

276 Banking Act of 1933, 12 U.S.C. s. 24 (1970). The act does not apply to foreign activities of United States banks, however, and underwriting in the Eurobond market is substantial for some United States banks (as it is for some Canadian banks). The act defines the powers of national (federally incorporated) banks. A number of the largest United States banks are state chartered and not directly subject to the act. But almost all of these are subsidiaries of bank holding companies which in turn are subject to the federal Bank Holding Company Act of 1956. The Federal Reserve Board has interpreted this act as imposing on subsidiary banks the limitations of the Glass-Steagall Act; *see* 12 C.F.R. s. 225.125(b)(1977).

The Securities Industry Association would like Congress to restrict the securities activities in the United States of organizations affiliated with foreign banks, just as it would like the activities of United States banks curtailed. *See* Securities

underwriting of public housing authority bonds and obligations issued by a state or municipality for housing, university or dormitory purposes which are at the same time eligible for purchase by a national bank for its own account. At one time the Comptroller of the Currency classified a number of bond issues that had been regarded as revenue bonds as eligible for bank underwriting. But this classification was later reversed.[277]

Representatives of the investment banking industry are of course bitterly opposed to the underwriting of revenue bonds by commercial banks.[278] There is some evidence, based upon careful research, that the participation of commercial banks in the underwriting of general obligation state and municipal bonds, and the exclusion of the banks from the underwriting of general revenue bonds, has reduced the cost to issuers of the general obligation bonds relative to the revenue bonds. In other words, the increased competition in underwriting general obligation bonds because commercial banks as well as investment bankers are eligible has benefitted issuing states and municipalities and these benefits are not present for revenue bonds.

In a 1971 article[279] Reuben Kessel analyzed spreads and reoffering yields for tax exempt general obligation bonds, revenue bonds, and so-called Saxon general obligation bonds (bonds that were reclassified from revenue to general obligations by Saxon when he was Comptroller of the Currency). The overall conclusion was that the prohibition of bank competition in the underwriting of revenue bonds has led to fewer bids for these bonds and higher underwriting costs. The revenue bonds that were of high quality, short maturity, and offered when business conditions were poor (all conditions that favour bank participation) were particularly disadvantaged.

An increased number of bids had two effects, both a higher reoffering price and a lower spread. The saving due to bank

Industry Association, Memorandum for Study and Discussion on Bank Securities Activities, at 4 (August 1976).

277 *See* Kessel, *A Study of the Effects of Competition in the Tax-Exempt Bond Market*, 79 J. Pol. Econ. 709 (July-August 1971).

278 *See e.g. Securities Activities of Commercial Banks: Hearings before Subcomm. on Securities*, *supra* note 195, at 268. The Investment Company institute supports this position, too; *id.* at 323-34. Further arguments can be found in *Financial Institutions: Hearings before Subcomm. on Financial Institutions*, *supra* note 200, pt. 3, at 2010-14, 2050, 2068-73 (December 1975-January 1976); *id.* pt. 4, 222-27, 585-87 (1976) (apps. A, B). Underwriting by affiliates of foreign banks was objected to (and statistics were cited) by New York Stock Exchange representatives in *The Financial Reform Act of 1976: Hearings before Subcomm. on Financial Institutions Supervision, Regulation and Insurance of the House Comm. on Banking, Currency and Housing*, 94th Cong., 2d Sess., pt. 2, at 671-74 (March 1976).

279 *See* Kessel, *supra* note 277.

underwriting effects on reoffering yields might be around thirteen basis points, while a saving of about 48¢ in underwriting spread might be achieved. Kessel argued that each bidder brings some unique information about his customers and therefore the greater the number of bidders the greater the representation of customers who will pay a high price for the new issue. In effect, the issuer is buying information about purchasers when it solicits bids.

Kessel explains why the absence of banks as underwriters is significant in view of the fact that no other financial entities are barred from the underwriting of revenue bonds. Commercial banks do bring some unique characteristics as underwriters, and investment and commercial bankers are complementary resources that benefit the issuers of general obligation bonds, but not the issuers of revenue bonds.

Legislation to allow banks to underwrite state and municipal revenue bonds was introduced in the House of Representatives as early as 1955. Further bills were discussed in 1963, 1965 and 1967.[280] In 1968 legislation was enacted authorizing commercial banks to underwrite and deal in investment quality housing, university, and dormitory revenue bonds. In 1974 the Senate Committee on Banking, Housing and Urban Affairs reported Bill S. 3838 which would have allowed banks to underwrite revenue bond issues eligible for purchase by national banks, subject to a number of conditions: underwritten bonds could not be sold to trust accounts; disclosure of underwriter status would have to accompany sales to depositors, borrowers or correspondent banks; and there would be limits to the size of positions taken and on transfers from underwriting to investment accounts.[281]

In its report, the committee noted that in 1940 only 12.6% of all new municipal bonds were in the revenue bond category and amounted to $188 million. By 1973 the percentage had grown to 44.1% and the dollar amount to $10 billion. The committee was impressed at the quality record of revenue bonds and the evidence that the competition from commercial banks in underwriting might be expected to reduce the cost to the issuing governments.

The Comptroller of the Currency testified in 1975 before Senator Williams' Subcommittee on Securities and Representative St. Germain's Subcommittee on Financial Institutions in favour of a change in the Glass-Steagall Act to permit bank underwriting of

280 *See Securities Activities of Commercial Banks: Hearings before Subcomm. on Securities, supra* note 195, at 211.

281 Financial Amendments Act of 1974, Report of the Senate Comm. on Banking, Housing and Urban Affairs, to Accompany S. 3838, S. Rep. No. 93-1120, 93d Cong., 2d Sess. (August 21, 1974).

municipal revenue bonds.[282] The American Bankers Association has urged the change and so has the Bank Commissioner of the State of Connecticut and the ad hoc Rhode Island Financial Institutions Committee.[283]

With respect to the supervision of bank securities activities by state securities regulatory authorities, the Bank Commissioner of the State of Connecticut offered some rather interesting testimony in 1976 before Senator Williams' subcommittee.[284] The Connecticut banking commissioner not only regulates banks but is responsible for the supervision of investment advisers and broker-dealers. He said that in Connecticut any banks engaging in the underwriting of municipal securities are required to register as broker-dealers. Personnel are required to take the same examination given by the National Association of Securities Dealers (NASD) and they are supposed to benefit from the same training. He said four banks were registered in Connecticut as broker-dealers of which one was a national bank. In commenting on the statement that it would be difficult to have bank employees register, as broker-dealer employees do, he said "I don't believe our experience indicates that at all". With respect to municipal underwriting he said that his office was in the process of revising its procedures to coincide with the new rules promulgated by the Municipal Securities Rule Making Board and the Securities and Exchange Commission.

The commissioner also noted that American banks undertake the underwriting of corporate securities on a very large scale overseas, and he could not see that this was doing any harm to the U.S. commercial banking industry. He questioned the argument that underwriting within the United States is too risky for commercial banks, when it does not appear to be too risky overseas. He also said that he regarded the entry of commercial banks into the dividend reinvestment area as an extension of their corporate trust activities. He said that he could see no harm to the public.

Some opinions of bank customers on the subject of commercial bank participation in underwriting may be of interest. Greenwich Research Associates reported in 1976 that most corporate execu-

282 *Securities Activities of Commercial Banks: Hearings before Subcomm. on Securities, supra* note 195, at 168; *Financial Institutions: Hearings before Subcomm. on Financial Institutions, supra* note 200, pt. 3, at 2418, 2456-57; HOUSE COMM. ON BANKING, FINE, *supra* note 223, at 417.

283 *Securities Activities of Commercial Banks: Hearings before Subcomm. on Securities, supra* note 195, at 293-94; *Financial Institutions: Hearings before Subcomm. on Financial Institutions, supra* note 200, pt. 1, at 667-78; *id.* pt. 4, at 372 (apps. A, B).

284 *Brokerage and Related Commercial Banks Services: Hearings before Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 94th Cong., 2d Sess. 718-36 (August and September 1976).

tives (60% of those interviewed) do not think that their banks should be allowed to offer investment banking services. However, the executives were evenly divided on the question of whether investment bankers were more able to handle their company's sophisticated financial needs then were their bankers.[285]

No legislation has been enacted to permit banks to underwrite revenue bonds but in 1975 Congress did remove the exemption from registration with the SEC of banks underwriting general obligation municipal bonds. These banks must now register as "municipal securities dealers".[286]

C. MONEY MANAGEMENT SERVICES OF BANKS AND TRUST COMPANIES

1. *Canada*

Canadian chartered banks are not permitted to operate trust departments. Some, however, do manage mutual funds, generally through a subsidiary. The 1976 government *White Paper* proposed[287] changes to prohibit this practice, but banks would be permitted to continue to act as sales agents for mutual funds managed by others. The reason for the proposed prohibition is the potential conflict of interest between the bank as lender to a corporation and as manager of a fund able to purchase the corporation's securities. The banks did not seem to object and the Senate Committee on Banking, Trade and Commerce approved the prohibition.[288]

Some banks also serve as advisers to real estate investment trusts (REITS) and to mortgage investment companies (MICS), which are very similar to mutual funds but invest primarily or exclusively in mortgages. Since banks are not permitted to operate trusts directly, the three banks that have established REITS have set up trusts with individual bank officers acting as trustees and the bank itself has served as adviser. The *White Paper* recognized the same potential for conflicts here as in the case of bank-managed mutual funds but it also saw the bank-managed REITS

285 GREENWICH RESEARCH ASSOCIATES, FOURTH ANNUAL REPORT ON LARGE CORPORATE BANKING 1976 (1976). The report was based on interviews with over 1,300 executives representing more than 900 companies during May and June of 1976.

286 Securities Exchange Act of 1934, ss. 3(a)(30), 15B. And *see, Securities Activities of Commercial Banks: Hearings before Subcomm. on Securities*, *supra* note 195, at 160. Another recommendation for bank underwriting of municipal revenue bonds was put forward in 1976; *see* HOUSE COMM. ON BANKING, "FINE", *supra* note 223, at 10.

287 WHITE PAPER ON THE REVISION OF CANADIAN BANKING LEGISLATION, *supra* note 202, at 36.

288 *Standing Senate Comm. on Banking, Trade and Commerce*, *supra* note 2, at 44:13,

and MICs as important vehicles for providing residential mortgage loans.[289] So the proposal was to continue to allow chartered banks to serve as advisers to REITs and MICs.

Bank-managed REITs do not enjoy any immunity from provincial securities regulation, at least in Ontario. In 1972 following the filing of preliminary prospectuses by Ontario's first two REITs, policy 3-25 was published by the Ontario Securities Commission setting out the conditions under which REITs (which were classified as "finance companies") would be permitted to issue securities.[290]

The bank as adviser is free of a registration requirement because banks need not register as advisers.[291] With respect to conflict of interest, the policy states:

> "[N]either the adviser nor any affiliate of the adviser shall engage in any business that would bring it in real or apparent conflict with the interests of the issuer [REIT]....[292]
>
> "[This] requirement may be waived in whole or in part by the Director where the adviser is a well established federal or provincial government supervised financial institution, *e.g.*, a bank, insurance company, loan or trust company."[293]

The waiver is critical since banks are in the mortgage business. Furthermore, mortgage funds organized by banks purchase their mortgages from the sponsoring bank and the transaction is hardly at "arms length". At the same time there is no significant secondary market in conventional mortgages in Canada that might serve to identify a "fair" price. The Ontario Securities Commission has had some difficulty with this conflict situation agreeing in one case that a spread up to 1/4% between the lending bank's yield and the investor fund's yield was reasonable but indicating that the subject was under review.[294]

44:69. The committee did favour permitting banks to act as advisers to mortgage-based mutual funds.

289 WHITE PAPER ON THE REVISION OF CANADIAN BANKING LEGISLATION, *supra* note 202, at 37.

290 Ontario Securities Commission Policy No. 3-25, first published in [1972] OSC Bull. 172 (September), 2 CCH CAN. SEC. L. REP. ¶¶ 54-919, 54-920 and amended subsequently.

291 Ontario Securities Act, s. 18(a). The same is true in other provinces.

292 OSC, Policy No. 3-25(F)(2), *supra* note 290.

293 OSC, Policy No. 3-25(F)(4), *supra* note 290.

294 *In re* s. 28 of the Securities Act and Scotiafund Mortgage and Income Trust, [1976] OSC Bull. 184 (July). The 1/4% spread, with some modifications, was made part of a formal policy in June 1977, when National Policy No. 29 was published; [1977] OSC Bull. 145-52 (July), 2 CCH CAN. SEC. L. REP. ¶ 54-867.

Registered Retirement Savings Plans and Registered Home Ownership Savings Plans are tax deferral arrangements designed to promote individual saving for retirement and home ownership. In both cases a trust is required and of course chartered banks may not manage trusts. However, banks may and do handle the sales and administration for these plans and some banks have set up mutual funds to serve as an investment vehicle for the trusts. The *White Paper* concluded that there is no reason why these plans should not be able to maintain deposits in banks and recommended that the trust requirement be abandoned. But the same potential for conflict of interest is present where banks invest money from these plans in bond and stock portfolios. So the *White Paper* proposed[295] that the banks not be permitted to accept any new clients for funds invested in stocks and bonds except where the management of the fund is independent of the bank. The securities industry has protested that the banks should not be permitted even to continue operating mutual funds for existing plan clients.[296]

So far as general portfolio management, investment counseling and securities advising activities are concerned, the *White Paper* proposed that only the management of REITS and MICS be allowed, plus casual securities advising in the course of serving bank customers.[297] The securities industry has expressed enthusiasm for the limitation but objects to the banks being able to offer casual securities advice.[298]

Under the present Ontario Securities Act, banks and trust companies are exempt from registration as advisers[299] which permits them to manage mutual funds without registration. There is no exemption from the Ontario prospectus requirements for mutual funds managed by banks or trust companies, although a fund offering only obligations guaranteed by a bank or trust company is exempt.[300] Bill 30 would continue the exemption for bank and trust company advisers[301] but would introduce the need to register as a management company in order to provide investment

295 WHITE PAPER ON THE REVISION OF CANADIAN BANKING LEGISLATION, *supra* note 202, at 39.

296 Joint Committee of the Canadian Securities Industry, Memorandum, *supra* note 267, at 18.

297 WHITE PAPER ON THE REVISION OF CANADIAN BANKING LEGISLATION, *supra* note 202, at 37. The banks have urged that they be allowed to advise mortgage-based mutual funds; *see* CANADIAN BANKERS' ASSOCIATION, BANK ACT 77, WHITE PAPER: THE BANKS' ASSESSMENT 10 (No. 4, 1976).

298 Joint Committee of the Canadian Securities Industry, Memorandum, *supra* note 267, at 12.

299 Ontario Securities Act, s. 18(a). The same is true in other provinces.

300 *Id.* ss. 19(2)1(c), 19(2)2.

301 Ontario Bill 30, s. 33(a).

advice to a mutual fund for compensation under a management contract.[302] The "contract" suggests that the management company and the mutual fund must be separate legal entities and therefore a bank or trust company would not have to register to manage a mutual fund that is part of the same bank or trust company. Mutual funds, however, will require registration under Bill 30,[303] except for trust companies offering securities of an account solely to service a Registered Retirement Savings Plan, a common trust fund, or a pooled account for which they do not solicit participations.[304] Banks do not qualify for this exemption which would not be necessary if the *White Paper* proposals are implemented. Grover and Baillie approve the exemption for trust companies because they are subject, in managing RRSPs, to the Ontario Pension Benefits Act.[305]

In acquiring securities for a pooled trust account a trust company presumably has the advantages of its exempt purchaser status and the potential problems under Bill 30, discussed above for regular trust accounts,[306] will apply.

The exemption for common trust funds will cover trust funds set up to service regular trust accounts but not the mutual funds operated by trust companies. Regular mutual funds operated by trust companies do not enjoy any exemptions from prospectus requirements nor would they under Ontario Bill 30. It appears that a fund set up entirely within the trust company would require the company to register as a management company. Trust company mutual funds are all "no-load" funds, so there is no "underwriting" and therefore no need even under Bill 30 for underwriter registration. Banks selling mutual fund shares would be subject to the underwriter registration requirement described above[307] but would not have to register to sell securities issued by a trust company for an RRSP account or a pooled account with no solicitation.[308]

Banks also offer miscellaneous administrative services that have to do with portfolios. These include the collecting of interest and dividends, custody of certificates, and periodic reports on portfolios. The *White Paper* saw nothing wrong in these activities because they do not pose any potential for conflicts of interest.[309]

302 *Id.* ss. 24(1)(e), 1(1)20, 1(1)21.
303 *Id.* s. 24(1)(d).
304 *Id.* s. 34(b).
305 *Grover & Baillie* at n. 268.
306 *Id.* at n. 216.
307 *Id.* at n. 275.
308 Ontario Bill 30, s. 35(2)4.
309 WHITE PAPER ON THE REVISION OF CANADIAN BANKING LEGISLATION, *supra* note 202, at 37

2. *United States*

We have already seen the substantial nature of the trust and agency activities carried on by U.S. banks. In managing a trust account a bank is managing funds to which it has legal title. An agency account involves the bank in money management or investment advisory activities with respect to assets that are not placed "in trust". Sometimes these advisory activities are carried out by subsidiaries of a parent bank holding company rather than by the bank itself. This form of money management is usually only practical for rather large accounts and a great deal of private pension fund money is managed in this way. Some banks have begun offering portfolio management services to small accounts (under $100,000). Charles Buek, president of U.S. Trust Co., described the economics of portfolio management to Senator Williams' subcommittee suggesting $200,000 as the minimum size for a separately managed account. But some "automatic" plans are feasible for much smaller accounts and of course commingled accounts offer economies for small accounts.[310] (The SEC found that 54% of the 290,000 separately managed personal trust accounts of the top 115 banks were under $100,000.)[311]

Individual Portfolio Management Service is an advisory service offered by some banks to individuals with portfolios as small as $10,000. Recommendations are sent by the bank to the customer who, if he accepts the recommendations, signs the form and sends it to his broker. Accounts are not pooled; the assets of an account may be held by the customer, the broker or the bank. At least one bank executes trades itself, thus offering some commission saving.[312]

Pension funds qualified under section 401 of the Internal Revenue Code, including Keogh plans for the self-employed and Individual Retirement Accounts under section 408, require trusts or custodial accounts with commercial banks, although the Secretary of the Treasury is authorized to designate non-bank trustees or custodians for IRAs.[313] Some Keogh plans and IRAs simply involve savings accounts but others give investment discretion to the bank. The section 401 pension plans and Keogh plan trusts are exempt from registration under the Securities Exchange Act of 1934 and Investment Company Act of 1940 and so are collective

310 *Securities Activities of Commercial Banks: Hearings before Subcomm. on Securities*, *supra* note 195, at 331-33.

311 SEC, FINAL REPORT, *supra* note 225, at 131.

312 *Securities Activities of Commercial Banks: Hearings before Subcomm. on Securities*, *supra* note 195, at 359-61.

313 *Id.* at 202-06.

trusts for these plans.[314] Keogh plans, however, and collective trust funds for Keogh plans are subject to the registration requirement of the Securities Act of 1933. The SEC may grant an exemption from this requirement and has done so by way of "no action" letters where the funds are invested in mutual funds for which a prospectus has been issued.[315] In many cases the bank makes use of the intrastate offering exemption under the Securities Act.[316]

IRAs are a little different. As in the case of the section 401 pension and Keogh plans, banks are authorized by the Internal Revenue Code to pool these accounts but there is no exemption from the registration requirements of the Investment Company Act of 1940 or the Securities Act of 1933. The SEC has issued "no action" letters contingent on there being no pooling of IRA accounts and the assets of an account being invested either in a savings account or in specific mutual funds, with no discretion on the part of the bank.[317]

Banks are permitted to pool regular trust accounts in so-called common trust funds, which can make it more economical to manage on a day-to-day basis the assets of fairly small trust accounts. (Pooled funds at the end of 1975 amounted to $18 billion.)[318] And these pooled funds are exempt from the Investment Company Act of 1940. But for investment management accounts, those that are not trust accounts, pooling is forbidden. At one time the Comptroller of the Currency authorized commingled agency accounts, which were in effect mutual funds. The SEC insisted that the common fund be registered as an investment company. But in 1971 the United States Supreme Court said that this practice constituted underwriting in violation of the Glass-Steagall Act.[319] Many commercial banks would like this decision changed by legislation and in fact the two legislative changes the American Bankers Association has been pushing hard for (and which the Comp-

314 Section 3(c)(11) of the Investment Company Act of 1940 exempts any collective trust maintained by a bank, consisting solely of assets of pension, bonus, and profit-sharing trusts qualified under s. 401 of the Internal Revenue Code.

315 *Securities Activities of Commercial Banks: Hearings before Subcomm. on Securities*, *supra* note 195, at 161.

316 *Id.* at 151.

317 *Id.* at 150–51, 204. The Comptroller of the Currency has said that bank examiners treat IRA accounts as regular trust accounts for purposes of supervision; *id* at 176.

318 SEC, FINAL REPORT, *supra* note 225, at 149.

319 Investment Company Institute v. Camp, 401 U.S. 617 (1971). The decision affirmed, however, the right of a national bank to manage the portfolio of an individual customer. The SEC position is that a commingled agency fund would not be exempt under the Investment Company Act of 1940; *see, Securities Activities of Commercial Banks: Hearings before Subcomm. on Securities, supra* note 195, at 154, 165. For a discussion of the events leading to the decision, *see* 2 INSTITUTIONAL INVESTOR REPORT at 447–50

troller of the Currency endorses)[320] would give banks the power to operate commingled agency accounts and the power to underwrite revenue bonds.

In addition to offering financial advisory services to individual non-trust accounts, a number of banks have begun to serve as investment advisers to both open-end and closed-end investment companies.[321] Sometimes the bank serves as the adviser but in most cases bank holding companies form separate investment advisory subsidiaries.

Banks themselves are exempt from registration under the Investment Advisers Act of 1940 but they are not excluded from the definition of "investment adviser" in the Investment Company Act of 1940. So they must register under the latter in order to manage investment companies.[322] And advisory subsidiaries of bank holding companies are not exempt from either act.[323] The SEC has raised a number of conflict of interest questions concerning banks that serve as custodian and transfer agent for closed-end investment companies that they also sponsor and manage but no action has ever been taken.[324]

The Board of Governors of the Federal Reserve System amended regulation Y in 1972 to allow bank holding companies and their affiliates to serve as advisers to registered closed-end investment companies and real estate investment trusts. The Investment Company Institute filed a petition with the Federal Reserve Board for reconsideration of this regulation. The request was denied and the institute filed a lawsuit which has not yet been decided on the merits.[325] While regulation Y does permit banks to advise investment companies, there are some restrictions imposed by the Federal Reserve Board of Governors that limit the activities of the banks to something less than what nonbank investment

320 *See, Securities Activities of Commercial Banks: Hearings before Subcomm. on Securities, supra* note 195, at 168-69 and 170-74; and further references at note 278 *supra*. And *see, Financial Institutions: Hearings before Subcomm. on Financial Institutions, supra* note 200, at 2437-38. The mutual fund industry of course argued strenuously against any such change; *id.* pt. 4, at 595, 601-03 (apps. A, B).

321 U.S. Department of the Treasury, Public Policy Aspects of Bank Securities Activities 8 (November 1975); *Securities Activities of Commercial Banks: Hearings before Subcomm. on Securities, supra* note 195, at 98-99; and *Financial Institutions: Hearings before Subcomm. on Financial Institutions, supra* note 200, pt. 4, at 594-97, 601 (apps. A, B).

322 Banks advise over $2 billion in investment company assets; SEC, Final Report, *supra* note 225, at 147-48.

323 *Securities Activities of Commercial Banks: Hearings before Subcomm. on Securities, supra* note 195, at 152-53 and 199-202.

324 *Id.* at 200.

325 ICI v. Board of Governors, Civil No. 74-697 (D.D.C. 1974). *See, Securities Activities of Commercial Banks: Hearings before Subcomm. on Securities, supra* note 195, at 114-15, 129-30, 201.

advisers may do. And bank holding companies are prohibited from sponsoring, organizing or controlling an open-end investment company or mutual fund.

The significant issue here is whether banks should be permitted to organize their own mutual funds. Many banks have substantial investment management staffs handling trust accounts and performing advisory services for large nontrust accounts. The kind of investor for whom mutual funds are likely to be most beneficial is probably foreclosed from making use of bank talent because it is not economical to open a trust account for a small investor. Besides, the banks are forbidden to solicit trust accounts in the expectation that the trust assets will be placed in a pooled trust fund.

Although investment companies are subject to the Investment Company Act of 1940, there is no comparable statute covering REITs. A bank holding company may organize a REIT investment management company as a wholly-owned subsidiary and the subsidiary will in turn organize the REIT as a separate company that offers shares to the public.[326] The SEC says it has no authority to regulate transactions between REITs and creditor banks but that federal disclosure requirements for bank holding companies and REITs apply to these "loan swaps".[327]

D. FINANCIAL ADVISORY SERVICES AND PRIVATE PLACEMENTS

In the preceding section we dealt with the provision of investment advice or investment advisory services by banks. Here we are concerned with financial advice to corporate customers.

1. *Canada*

The government *White Paper* of 1976 did not mention advisory activities of chartered banks, but proposed that the right of a bank to act as an agent in the private placement of corporate securities would be withdrawn.[328] The securities industry appar-

326 *Securities Activities of Commercial Banks: Hearings before Subcomm. on Securities*, *supra* note 195, at 201-02; and *see id.* at 140, 144, 153.

327 *Id.* at 165-66. There are those who argue that a serious regulatory gap exists here or at least that the relationship between the bank and the REIT poses serious risk to the bank; *see, Financial Institutions: Hearings before Subcomm. on Financial Institutions*, *supra* note 200, pt. 1, at 496-99, 507-16 (December 1975).

328 WHITE PAPER ON THE REVISION OF CANADIAN BANKING LEGISLATION, *supra* note 202, at 35. The banks have generally accepted a proposed prohibition of underwriting corporate activities but do want to continue private placements; CANADIAN BANKERS' ASSOCIATION, *supra* note 297, at 10.

ently feels there may still be too much freedom for banks to help their customers arrange private placements.[329]

Even if the bank's role as agent in a private placement constitutes "trading" within the meaning of the Ontario Securities Act, there is an exemption from registration.[330] Bill 30 would remove this exemption but almost certainly the placement would be to "exempt purchasers" and therefore exempt.[331]

2. *United States*

Financial advisory services are essentially management consulting services and are usually provided through a separate nonbank subsidiary of a bank or its holding company. The service may be on the basis of a long-term contract or may be provided to customers for specific projects.[332]

There seems to be no claim that these services are prohibited by the Glass-Steagall Act. However, there is apparently some uncertainty about giving advice to corporate clients in mergers and acquisitions and with respect to private placements which may involve the issue of securities.[333] At some point the advisory services may become underwriting. The Securities Industry Association claims that even syndicating long-term bank loans is suspect.[334] The Comptroller of the Currency is concerned that the penalties for violation of the Glass-Steagall Act may inhibit legitimate financial advisory services and would like to see those penalties removed.[335]

Rendering advice on private placements of long-term securities is an activity that has sparked an especially sharp debate

329 Joint Committee of the Canadian Securities Industry, Memorandum, *supra* note 267, at 7.

330 Ontario Securities Act, s. 19(1)3. The other provinces provide the same exemption.

331 Ontario Bill 30, ss. 35(1)3, 4.

332 U.S. Dept. of the Treasury, Public Policy Aspects of Bank Securities Activities, *supra* note 321, at 9, *reprinted in Securities Activities of Commercial Banks: Hearings before Subcomm. on Securities, supra* note 195, at 33.

333 Two letters from the Deputy Comptroller of the Currency in 1974 and 1975 describing permissible private placement activities are reproduced as apps. IIA and IIB, in Securities Industry Association, Memorandum for Study and Discussion on Bank Securities Activities (August 1976).

334 *Id.* at 10.

335 U.S. Dept. of the Treasury, *supra* note 321, at 24-25, *reprinted in Securities Activities of Commercial Banks: Hearings before Subcomm. on Securities, supra* note 195, at 172. There was a brief flurry over private placements in early 1977 when the Federal Reserve Board ordered First Arabian Corp., a bank holding company, to divest its interest in Bates North America, a broker-dealer, because of the latter's activity in private placements. The Federal Reserve replied to inquiries that this decision was quite unrelated to questions of bank activities under the Glass-Steagall Act.

between the banks and the securities industry. Representative Henry Ruess, chairman of the House Banking, Currency and Housing Committee, asked the Federal Reserve Board in December 1976 for a study of private placement activities of commercial banks. The Securities Industry Association prepared a memorandum to the board[336] arguing that commercial banks are prohibited by the Glass-Steagall Act from advising on private placements and that dangers of reciprocal practices and conflicts of interest make the banks' activities undesirable. The New York Clearing House Association also prepared a memorandum[337] defending the legality and propriety of the activities.

The Federal Reserve Board *Staff Study* concluded that there was "no evidence of significant legal or public policy problems associated with commercial bank private placement activities".[338] The study reported (quoting the SEC) that there were twenty-two commercial banks that in the five years from 1972 to 1976 had assisted in more than an incidental way in private placements; there were eighteen banks active in private placements in 1976 and five banks accounting for almost 90% of the bank advisory activity.[339] All of the banks accounted for 7% of $16 billion of assisted private placements in 1976 and although the percentage was up from 2% in 1972, it had remained fairly constant for 1975 and 1976.[340]

The study saw little chance of banks displacing investment bankers as the dominant intermediaries (the top ten investment banks in terms of private placement activities had 67% of the advisory business in 1976 and the leading commercial bank was in thirteenth place).[341] Commercial banks did tend to specialize in lease financings, a field of U.S. bank expertise, and in 1976 participated in 15% of assisted lease financings.[342] On the other hand, banks participated in relatively few of the very large private placements (such as those of Hydro Québec, Ontario Hydro and B.C. Hydro).[343] Bank assisted private placements seemed to be of

336 Securities Industry Association, Private Placement Activities of Commercial Banks; Memorandum to the Federal Reserve Board (May 1977).

337 New York Clearing House Association, *Commercial Bank Private Placement Advisory Services: An Analysis of the Public Policy and Legal Issues* (April 1977), *reprinted in* 95 Banking L.J. 333 (1978).

338 Staff of Federal Reserve Board, Commercial Bank Private Placement Activities 5 (June 1977).

339 *Id.* at 66, 32, 33.

340 *Id.* at 26, 31. More detailed statistics appear in SEC, Final Report, *supra* note 225, at 61-74.

341 Staff of Federal Reserve Board, *supra* note 338, at 59.

342 *Id.* at 35-36. SEC, Final Report, *supra* note 225, at 75-89, deals extensively with lease-related placements.

343 Staff of Federal Reserve Board, *supra* note 338, at 32-34.

generally high quality and the average fee charged in 1976 was 0.8%.[344]

If the bank makes use of a subsidiary to provide financial advisory services, then the Comptroller of the Currency must approve the creation of that subsidiary. The comptroller has explicitly authorized national banks to provide such advisory services.[345]

Investment banking firms see the bank activity as competitive and frequently unwelcome. There is also a claim that the banks through their commercial lending activities are already direct competitors with underwriters who might handle public offerings. If they also provide the advice that might help a client choose between bank loans and publicly offered securities, the banks may be in a very powerful position and there are possibilities for conflicts of interest.[346] The SEC says that provision of these financial services would call for registration as a broker-dealer were it not for the exclusion of banks from the definitions of "broker" and "dealer" in the Securities Exchange Act.[347] The commission does not argue against this exclusion but it has argued that bank personnel engaged in corporate financing services should be required to pass tests of competence.[348]

A number of banks offer advice on mergers, acquisitions and divestitures. Thirty-three banks responding to the SEC questionnaire indicated that they were engaged in this activity during 1972 to 1976, although seven had discontinued it and only seventeen reported fees or collections for the first nine months of 1976.[349] The number of transactions reported by banks never exceeded 3% of the total number of transactions reported by the Federal Trade Commission for 1972 to 1975.[350]

E. AGENCY AND BROKER SERVICES

1. *Canada*

Canadian chartered banks appear to be free to offer brokerage services but none of the banks hold stock exchange member-

344 *Id.* at 54. An excellent description of the private placement process is given in IRVING TRUST COMPANY, GUIDELINES FOR THE PRIVATE PLACEMENT OF DEBT SECURITIES (New York 1976).

345 U.S. DEPARTMENT OF THE TREASURY, *supra* note 321, at 35.

346 *Id.* at 24; *Securities Activities of Commercial Banks: Hearings before Subcomm. on Securities*, *supra* note 195, at 260-63, 277.

347 SEC, INITIAL REPORT ON BANK SECURITIES ACTIVITIES 5 (January 1977).

348 SEC, FINAL REPORT, *supra* note 225, at 5, 18-19.

349 *Id.* at 94-95.

350 *Id.* at 99.

ships or own broker-dealer firms. Apart from transactions that can be completed among their own customers, they appear to make use of regular broker-dealers even when they serve as brokers. However, they do serve as agents in the sale of commercial paper for corporate customers. The *White Paper* proposals would leave the banks free to act as brokers and also to advertise this function. The securities industry has protested and urged a ban on the solicitation of brokerage business by banks. The securities industry would also like to see a requirement that the banks would be required to use a registered securities firm even for unsolicited orders.[351] And the industry has urged that banks be prohibited from soliciting sales of corporate commercial paper.[352] The banks, on the other hand, would like their right to deal in securities to be made clearer, and they oppose any requirement that they be subject to provincial registration requirements.[353]

Although chartered banks act as market-makers in some bonds, usually those on the head office "approved list", there is apparently not much interest in equity market-making.

Banks and trust companies are not required to register under the Ontario Securities Act in order to act as brokers or dealers[354] but Bill 30 would drastically narrow this exemption. Registration would not be required for a trade involving only the placing of an unsolicited order to purchase or sell with a bank for execution through a registered dealer.[355] The handling of unsolicited orders, of course, is precisely the kind of bank activity of which the securities industry approves and is what makes up almost all the bank brokerage function according to the banks' own testimony.

Like anyone else, of course, the banks are free to act as brokers and dealers without registration in government and municipal securities and securities guaranteed by banks, trust and loan

351 Joint Committee of the Canadian Securities Industry, memorandum, *supra* note 267, at 20.

352 *Id.* at 21-23.

353 Canadian Bankers' Association, *supra* note 201, at 28.

354 Ontario Securities Act, s. 19(1)(3). The other provincial acts contain the same exemption. In a puzzling decision in 1974, however, the Ontario Securities Commission made an order that the registration requirements of the act would not apply to banks that might act as selling group members in a nation-wide offering by the Canada Development Corporation. The commission does not refer to the statutory exemption and suggests that the activity it is authorizing is quite unusual. This particular underwriting aroused rather strong feelings within the investment industry which did not welcome bank participation (and in the end the banks did not participate). The order was granted at the request of CDC and it seems likely it was requested to head off any attempt to have the commission deny use of the exemption which it was empowered to do under section 19(5); *In re* Canada Development Corporation, [1974] OSC Bull. 76-80 (April)

355 Ontario Bill. 30, s. 35(1)10(b).

companies and insurance companies.[356] Ontario Bill 30 preserves this exemption.[357]

2. *United States*

Banks in the United States offer a number of agency services giving customers access to securities markets. So far banks have not undertaken to conduct a retail brokerage business on a significant scale, although it is not entirely clear whether they are permitted to do so under the Glass-Steagall Act.[358] But there is evidence that banks are seeking closer relations with particular brokerage firms and these relationships coupled with the unfixing of commission rates in the United States can probably accomplish anything that a bank might seek to accomplish through providing brokerage services directly.

Banks provide customers with custodial services; indeed the usual custodian of an institutional portfolio will be a commercial bank. The custodial account differs from the trust account in that custodianship simply involves safekeeping and the transfer of securities into and out of the custodial account. There is no investment management on the part of the bank. A custodial account can involve collection of income by the bank and quite possibly reinvestment of this income in short-term funds. The bank may simply deliver and accept securities on the customer's instructions or it may buy and sell securities at the direction of the customer or his investment adviser. The purchases and sales will be undertaken by the bank acting as an intermediary between the customer and a broker or dealer. Custodial arrangements do to some extent involve competition with the securities industry but there appears to be little resentment over them on the part of brokers and dealers and there have been no obvious efforts to have them curtailed.

At least one bank has provided a voluntary investment plan. A broker-dealer would refer customers with small accounts to the bank. The bank would establish a custodial account for each customer and arrange for a monthly purchase of securities chosen by the customer from a list of recommendations from the broker-dealer. The customer would pay a fee based on the size of his

356 Ontario Securities Act, s. 19(2).

357 Ontario Bill 30, s. 35(2)1.

358 *Securities Activities of Commercial Banks: Hearings before Subcomm. on Securities*, *supra* note 195, at 114, 124–29, 152. The Securities Industry Association has complained about banks dealing directly with third market makers as agents for customers. Securities Industry Association, Memorandum for Study and Discussion on Bank Securities Activities, at 5 (August 1976).

investment account, and the fee would cover all commissions and bank service charges. Part of the fee would be rebated to the broker-dealer.[359]

Automatic investment plans are a somewhat similar service offered by banks but in this case the bank rather than the broker-dealer takes the initiative in soliciting customers and it is the bank that offers a list of the stocks of the twenty-five largest corporations in Standard & Poors Industrial Index from which the customer makes a selection. The plan involves monthly purchases through transfers from the customer's checking account and a service fee is charged for each transaction. The bank is able to pool customer orders to reduce commission costs. The monthly service charge is 5% of the amount invested with a maximum of $2 or $3 a month per stock purchased plus brokerage. Usually there is no custodial account; securities are held in a bank nominee name and are transferred to the customer on request.[360]

Automatic investment plans have generally been regarded by the SEC as not requiring registration under the Investment Company Act of 1940 or the Securities Act of 1933,[361] and the Comptroller of the Currency has said they do not violate the Glass-Steagall Act.[362] The New York Stock Exchange and the Investment Company Institute failed in an attempt to have automatic investment plans declared in violation of the Glass-Steagall Act.[363] Legislation was introduced in 1974 to bring these plans under SEC regulation but nothing was enacted.[364] The number of banks and customers participating in these plans has declined since 1974 and in late 1976 only eighteen banks were offering plans with some 4,500 participants.[365]

Another service offered by many banks is the dividend reinvestment plan. Through this plan shareholders of a participating corporation direct that their dividends be paid to a bank which aggregates all the dividends received and purchases shares of the corporation's common stock, sometimes directly from the corporation but more often in the market. (Direct purchases sometimes benefit by a discount from market price.) Such plans have apparently grown substantially in recent years, as corporations have

359 SEC, Initial Report, *supra* note 347, at 72.

360 Operation of the plans is described in detail, *id.* at 55-71.

361 *Id.* at 194-95.

362 *Id.* at 195.

363 NYSE v. Smith, 404 F. Supp. 1091 (D.D.C. 1975). For discussion *see, Financial Institutions: Hearings before Subcomm. on Financial Institutions, supra* note 200, at 2077-79, 2083-84; and *see id.* pt. 4, at 588-91 (apps. A, B).

364 *Securities Activities of Commercial Banks: Hearings before Subcomm. on Securities, supra* note 195, at 195.

365 SEC, Initial Report, *supra* note 347, at 54, 63.

become enthusiastic. The SEC reported in 1977 that sixty-eight banks offered these plans with over 1.8 million participating shareholders in 727 corporations and assets of $1.2 billion.[366] It is also possible in most of these plans for the shareholder to add additional funds to purchase more shares and the additions commonly amount to about five times the reinvested dividends. Service fees usually range from 4% to 5% of the investment but are sometimes less and there is usually a maximum of $2 to $3.[367] Sometimes the corporation pays both the service fee and commissions.[368] The plans are apparently not profitable for the banks offering them nor for Merrill Lynch which also offers them.[369]

Dividend reinvestment plans, whether offered by banks or by others, have generally been considered by the SEC as not subject to registration under the Investment Company Act of 1940 or the Securities Act of 1933 because they do not involve separate securities.[370]

Employee stock purchase plans (ESPPS) are a further bank service. They operate much as do dividend reinvestment plans with a pooling of participants' funds to purchase shares in large quantities. Although they were first offered by banks before dividend reinvestment plans, they are much smaller in the aggregate. The SEC reported in 1977 that fifty-nine banks were offering 105 ESPPS with 165,000 participants and $121 million in assets.[371] Some brokers also offer ESPP services and the SEC concluded that large banks and brokerages have a competitive edge over small banks and brokerages. But banks in general do not have the competitive advantage over brokerages that they enjoy with respect to dividend reinvestment plans.[372] Total direct costs of bank administered ESPPS were probably a little under 3%, while the cost of the plans administered by Merrill Lynch was 1.87%.[373]

The banks argue that in operating dividend reinvestment plans and automatic investment plans they simply function as

366 *Securities Activities of Commercial Banks: Hearings before Subcomm. on Securities*, *supra* note 195, at 93-97; SEC, INITIAL REPORT, *supra* note 347, at 15, 37.

367 *Securities Activities of Commercial Banks: Hearings before Subcomm. on Securities*, *supra* note 195, at 353-55; SEC, INITIAL REPORT, *supra* note 347, at 15-35 describes the plans in detail.

368 SEC, INITIAL REPORT, *supra* note 347, at 34.

369 *See, Brokerage and Related Commercial Bank Services: Hearings before Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 94th Cong., 2d Sess. 87, 215 (August and September 1976).

370 SEC, INITIAL REPORT, *supra* note 347, at 106, 192-93. The conditions under which exemptions are granted are described *id.* at 151-52. Automatic investment services are not so easily exempted; *see also id.* at 162.

371 *Id.* at 27.

372 *Id.* at 43-45.

373 *Id.* at 53.

agents of their customers, while the securities industry claims they go beyond permissible dealing "and may violate the ban on underwriting".[374] The securities industry also argues that customers of dividend reinvestment plans and automatic investment plans are not protected by the "suitability requirement", and that neither Securities Investor Protection Corporation, nor Federal Deposit Insurance Corporation insurance applies.[375] Of course, the so-called "discount" brokerage firms offer customers an execution-only service with no recommendations or assurance of suitability. The witnesses representing the brokerage community before congressional committees have generally expressed no opinion about the propriety of this kind of operation.

Bank personnel are not required to demonstrate knowledge of securities laws or be registered by the NASD or SEC.[376] Standards of record-keeping, executions, and confirmations are less strict for banks. And advertising is said to be subject to less control.[377]

The voluntary investment plan, automatic investment plan, and dividend reinvestment plan have been subject to a great deal of criticism from the brokerage industry. The real fear seems to have been that this channeling of transactions through banks will lead to reduced commissions to regular brokers. But it also appears that these services are not widely available to small investors through brokers so that the banks are serving a genuine need.[378] The arguments advanced against these bank practices and in favour of legislation to prohibit them include the familiar claim that investment will be concentrated in a few favourite stocks with the others left to languish. The conflict of interest argument that has been raised in connection with trust activities of commercial banks has also been raised in connection with these three investment and reinvestment plans. It has also been argued that the handling of customer accounts in these plans is not necessarily in the best interest of the customer; the use of cash balances may not be in the customer's best interest; he may or may not get the best execution available; and there may be conflicts involving

374 *Id.* at 126-28. A wish to avoid obvious competition with brokers apparently is the source of upper limits of $1,000 per month or $3,000 per quarter usually imposed by the banks on optional additional cash payments from customers; *id.* at 19. In any case, 90% of the secondary market purchases were executed by brokers; *id.* at 28.

375 *Id.* at 109, 152, 162-63.

376 *Id.* at 110.

377 *Id.* at 111-13.

378 There is some difference of opinion here. Some say bank-sponsored dividend reinvestment plans have been very successful because brokers do not offer the same service. Merrill Lynch has argued the banks enjoy unfair competitive advantages;

those very executions when the bank has many customers to consider including its own trust department clientele. There is also the argument that the securities business, if it becomes substantial for the banks involved, may significantly increase the risk of the entire banking operation.[379] It seems unlikely that any commercial banks are anywhere near this point at the present time but some critics clearly fear that so long as banks are engaging in these securities activities it may be increasingly difficult to keep them out of underwriting and ultimately a full-scale securities business.

There seems to be some evidence that these plans are channeling savings into common stock investments[380] and that genuine cost savings are being achieved by the individual investors, particularly with respect to the reinvestments of dividends; without these plans the cost of reinvestment might be almost prohibitive. However, the total value of orders effected by banks for these services is estimated by the SEC as only 0.9% of all transactions on national stock exchanges and new equity raised is estimated at only 4.4% of new equity financing.[381] Overall, the SEC has concluded:

> "Banks dominate the DRP [dividend reinvestment plan] market and have achieved rapid growth in this area in recent years. Banks have a secondary role in the administration of ESPPS [employee stock purchase plans]; moreover, growth of this service has been relatively modest. Banks offering the AIS [automatic investment service] have declined in absolute terms from twenty banks in 1974 to eighteen banks in 1976, reflecting a lack of demand for this type of service whether offered by banks or broker-dealers. Information obtained from staff interviews with a number of bankers involved in the CTS [brokerage services for customers] suggests little or no growth of this informal service over the past two years."[382]

Table 53 shows the magnitude of the bank activities.

Banks are explicitly excluded from the definition of "broker"

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id. at 93-102. Merrill Lynch is one of only two brokerage firms offering dividend reinvestment plans; *id.* at 15.

379 *Id.* at 96, 100-04, 116-21, 241-44, 266-70, 313-16.

380 *Id.* at 5, 138. The New York Stock Exchange disputes this decision, but does not claim that comparable services are available from brokers; *see, Financial Institutions: Hearings before Subcomm. on Financial Institutions, supra* note 200, at 2085-86.

381 SEC, INITIAL REPORT, *supra* note 347, at 10. Dividend Reinvestment Plans account for almost all the new equity.

382 *Id.* at 11-12.

Table 53
Scope of Bank Brokerage-Type Plans in the United States

	Approximate number of banks currently offering service	Estimated number of individual participants	Average investment by participants per quarter	Estimated market value of transactions as percentage of all transactions on national stock exchanges	Estimated market value of new equity capital raised as percentage of all new capital raised
Dividend reinvestment plan	68	1,900,000	$ 72	0.1%	4.3%
Employee stock purchase plan [a]	59	165,403	84	0.014	0.1
Automatic investment service	18	4,543	225	0.006	N/A
Customer transaction service	4,300	[b]	[b]	0.8	N/A
Total	N/A	N/A	N/A	0.9	4.4

a. Not projected to the universe of banks; based on data compiled from 255 banks out of 261 surveyed.
b. 10,348 orders were placed through banks in the survey sample in October 1976; average order size was $11,516.
Source: Securities and Exchange Commission, *Initial Report*, p. 13, *supra* note 347.

and "dealer" in sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934 and therefore need not register as such. Section 16 of the Glass-Steagall Act permits national banks to deal in securities upon the order and for the account of customers. There appears to be substantial doubt as to the precise limits of the permissible dealing. The securities industry believes the intent of the act was to permit banks to "accommodate" regular customers. The banks, on the other hand, contend that section 16 was intended to facilitate such activities as automatic investment services.[383]

Banks have traditionally offered an agency service to customers buying or selling securities by transmitting their orders to a broker-dealer. The SEC study said of this service:

> "Customer transaction service is not, however, a formal bank service like the bank services discussed in earlier chapters [dividend reinvestment, employee stock purchase, automatic investment plans]. Indeed, with the exception of a service presently being tested by Chemical Bank, discussed below, customer transaction service is a distinctly informal service provided as an accommodation to bank customers...is rarely mentioned in bank literature, and, viewed separately, is uniformly unprofitable to the bank. Nonetheless, the responses to the Bank Study Questionnaire show that more banks offer this informal service than all of the formal bank services combined."[384]

Bank service fees ranged from $15 to $25 per transaction but may be reduced or even waived for regular banking customers. Small transactions may cost less when placed through a bank than when placed directly with a broker-dealer.[385]

In September 1976, the Chemical Bank announced that it would offer to its customers a stock brokerage service at cut-rate commissions. Customers would be able to buy and sell listed securities and most unlisted securities at commission rates well below those being charged to individual investors by major brokerage houses. Chemical would act as agent with the actual execution of orders handled by Pershing & Company,[386] a widely known execu-

383 *Id.* at 124-26. And *see, Financial Institutions: Hearings before Subcomm. on Financial Institutions, supra* note 200, at 2079-83; and *see id.* pt. 5, at 226-27, 588-91 (apps. A, B).

384 SEC, Initial Report, *supra* note 347, at 78.

385 *Id.* at 87-88.

386 Chemical Bank stressed the use of a member firm. Neff, testifying on behalf of the bank before Senator Williams' subcommittee, said that "[t]he bank will not be executing brokerage transactions or in any way usurping the traditional broker-

tion firm, able since the change in the fixed minimum commission rule in May 1976 to negotiate inter-broker transaction costs. The relationship between Pershing and Chemical was probably an "omnibus" account which means that Pershing would treat Chemical as a single customer. Customers joining the program would be charged a flat $30 annual membership fee. Each purchase or sale up to 500 shares of any price stock would carry a $35 commission. Trades beyond 500 and up to 1,000 shares would carry a $55 charge. Trades above 1,000 shares would be subject to negotiation. The saving would be greatest on higher-priced shares and the Chemical Bank service would be more expensive for small orders of low-priced shares. The fees would not include safekeeping and research.

The Securities Industry Association reacted to the Chemical Bank plan with public denunciation and apparently undertook to approach the Federal Reserve for help in stopping the new plan. At the same time SEC commissioner John Evans said that the best way for the individual investor to achieve significant discounts in execution costs is through grouping arrangements like the proposed Chemical Bank plan where the broker-dealer is guaranteed a substantial flow of small orders. He said the cost savings did not depend on individual orders being held to make up block transactions but that the guarantee of a flow of small orders was enough to achieve the low commission rate.

The combination of the Chemical Bank and Pershing & Company put executions in the hands of a member firm that had an excellent reputation for good executions at low cost and the processing and reporting in the hands of a bank that could use monthly checking account statements to report all aspects of securities transactions. Custodial services would of course be available to customers at some fee. There was at least the potential here for a very efficient brokerage service.

The plan was apparently not successful enough in attracting business to justify the political struggle it precipitated and it was dropped in February 1977. In the fall of 1977, however, Citicorp, the holding company for the First National City Bank (and the largest bank holding company in New York city) disclosed the formation of a broker-dealer affiliate. Initially this firm was to sell Citicorp securities to investors but it was apparent that a broker activity was planned.

The securities industry has steadily maintained that bank securities activities present unfair competition to broker-dealers

dealer function"; *Brokerage and Related Commercial Bank Service: Hearings before Subcomm. on Securities, supra* note 369, at 217.

because the banks are subject to less strict regulation and that bank regulation does not provide adequate investor protection. In its second report to Congress on bank securities activities, in February 1977, the Securities and Exchange Commission compared the regulation of banks offering money management services with the regulation of broker-dealers.[387] Both banks and broker-dealers are subject to the anti-fraud provisions of the federal securities laws, in particular the provisions of the Securities Exchange Act of 1934. By and large these provisions deal with fraud in the purchase and sale or offering of securities and not with the offering of securities-related services. Periodic investment plans that involve the issue of new securities will be subject to the Securities Act of 1933 including its limitations on advertising and sales literature. Apart from these requirements, however, banks are free from the regulation of advertising that is imposed on broker-dealers.

The stock exchanges require that members submit advertising for approval before publication and that market letters and research reports be cleared in advance by a qualified employee of a member firm. Literature of member firms must also comply with specific standards of truthfulness and good taste established by the exchanges.[388] The NASD has its own rules applying to the publication of advertising material and market letters and requires that they be approved by a qualified supervisor in the firm and comply with substantive standards relating to their content.[389] The SEC still has not established rules for broker-dealers who are not members of an exchange or the NASD and the SEC does not review their advertising apart from the sales literature of investment companies. The SEC has said, however, that they too should comply with all of the NASD substantive guidelines.[390]

Banks are subject to very little regulation with respect to advertising their services. Regulations of the Comptroller of the Currency prevent banks from promoting collective investment funds to attract new business and the Federal Reserve Board prohibits bank holding companies from distributing advertising materials for investment company shares.[391] There is also a difference between the regulation of banks and the regulation of broker-dealers with respect to the "know your customer" or "suitability" rule. Within the broker-dealer community the rule is not

387 Securities and Exchange Commission, Second Report on Bank Securities Activities (February 3, 1977).

388 *Id.* at 13–14.

389 *Id.* at 15–17.

390 *Id.* at 18.

391 *Id.* at 20.

uniform. The stock exchanges impose an obligation on members to know their customers but have not adopted the detailed suitability requirements that are imposed by the NASD on its members (except for transactions on stock exchanges) and by the SEC on broker-dealers who are neither NASD nor stock exchange members. The NASD and SEC rules both require that the broker-dealer take pains to determine that a recommendation be suitable for a customer.[392] There is some question whether the periodic investment plans, whether sponsored by banks or by broker-dealers, involve any "recommendation". And there is certainly a question whether it makes sense to demand the suitability investigation in connection with these services. In any case, these suitability rules are not applied to banks in the operation of their periodic investment plans. The Comptroller of the Currency has expressed the opinion that the suitability requirement probably does not mean much anyway and in any event should not apply to periodic investment plans.[393]

There are some differences between the treatment of broker-dealers and banks with respect to regulation concerning the character, competence and supervision of employees handling securities-related activities. In both cases there are checks on honesty and good character. For the broker-dealers these are found in the Securities Exchange Act and the policies of the exchanges and the NASD.[394] For the banks the Federal Deposit Insurance Corporation (FDIC) prohibits the employment by an insured bank of any person who has been convicted of a criminal offence involving dishonesty or a breach of trust.[395] Broker-dealers seem to be somewhat more tightly regulated than banks in terms of responsibility for the supervision of employees engaged in securities activities. The Securities Exchange Act of 1934 spells out a responsibility to supervise; the exchanges also require that appropriate personnel be designated to exercise supervisory responsibility; and the NASD not only requires the designation of supervisory officers but also requires written supervisory procedures and specific periodic review of the work of registered representatives.[396] The Comptroller of the Currency, the Federal Reserve Board, and the FDIC all direct examiners to look generally at personnel policies, adequacy of staff, and adequacy of supervision but there appears to be nothing analogous in their regulation to the specific direc-

392 *Id.* at 27. Securities Exchange Act of 1934, rule 15b10-3. The NYSE proposed in 1977 to relax its rules but met with SEC opposition.

393 *Id.* at 34.

394 *Id.* at 37-45.

395 *Id.* at 45.

396 *Id.* at 43.

tions of the Securities Exchange Act, the stock exchanges and the NASD.[397]

On the subject of competence of employees the NASD requires that principals and representatives pass appropriate qualifying examinations; the New York Stock Exchange and American Stock Exchange require experience, training, and examinations; and the staff of the SEC is currently considering what uniform minimum standards should be established for the entire broker-dealer industry in compliance with the 1975 revision to section 15(b) of the Securities Exchange Act.[398] Banks do not appear to be subject to any specific regulation with respect to the competence of employees engaged in securities activities and the SEC has said that it does not believe that specific competency and examination standards should apply to bank officers and employees dealing with the public.[399]

The Securities Exchange Act rules on record keeping are much more specific than any banking laws or rules, but as a practical matter bank examination procedures appear to call for record keeping that the SEC would regard as adequate for securities-related activities.[400] Broker-dealers are subject to more specific rules with respect to fidelity bonding of employees than are banks, but bank employees are covered by bonding.

A broker-dealer is able to use customer cash balances to finance transactions in customer margin accounts, to finance fail-to-delivers, and to finance short sales by customers.[401] Banks may be able to hold such balances as regular deposits but can do no more with them.[402] Broker-dealers are in many instances able to pledge as security for their own borrowing securities purchased by their customers on margin. Banks, on the other hand, are not free to pledge or otherwise use customer securities.[403]

The SEC report concluded that with respect to the execution of customer orders the standards imposed by regulation on banks do not differ from the standards imposed on the broker-dealers, except that stock exchange rules prohibit broker-dealers from completing a transaction in listed securities as an in-house cross. Banks are permitted to cross orders in formal brokerage plans in accordance with customer agreements.[404]

397 *Id.* at 50.
398 *Id.* at 40-45.
399 SEC, Final Report, *supra* note 225, at 21. Other activities, including trading, however, may require such standards.
400 SEC, Second Report, *supra* note 387, at 56.
401 *Id.* at 83.
402 *Id.* at 85-86.
403 *Id.* at 88, 89-90.
404 *Id.* at 107.

Confirmations of transactions to customers by banks include brokerage commissions as part of the price per share, so that customers cannot identify the commission paid and compare it with commissions charged by brokers, whereas confirmations from broker-dealers show separately the brokerage commissions paid. Otherwise, the SEC study found no significant difference between broker-dealer confirmations and bank confirmations.[405] The SEC has urged more complete disclosure in bank confirmations so that customers can compare transaction costs.[406]

In September 1977 the commission completed proposed legislation to implement its recommendations. The legislation would not bring bank securities activities under SEC jurisdiction but would require the bank regulatory agencies to establish rules and regulations.[407]

F. CONCLUSIONS AND POLICY IMPLICATIONS

In both Canada and the United States the question of the participation of financial institutions in the securities markets is complicated by divided jurisdiction. Financial institutions and the securities industry are governed by different statutes and regulated by different agencies. In Canada the picture is further complicated by a significant division between federal and provincial regulation. In the United States, banking is substantially under federal control and so is regulation of the securities markets and the securities industry.

The Bank Act determines essentially the permissible activities of the Canadian chartered banks. The policies underlying this act are heavily influenced by the Department of Finance. The securities industry and securities markets are at present regulated under provincial statutes and by provincial securities commissions. So while the Bank Act establishes *what* banks may do with respect to securities activities, *how* they do it is left to provincial regulation. Yet even this distinction is not entirely clear, and the banks argue that the provinces do not have jurisdiction to regulate their activities. A federal regulatory commission having jurisdiction over securities markets and the securities industry might help to clarify the position of the banks and might offer some hope for a consistent position on what banks are permitted to do and how they are to do it.

Whether bank securities activities including underwriting,

405 *Id.* at 112-13.

406 SEC, FINAL REPORT, *supra* note 225, at 32-33.

407 Letter from the SEC to the Speaker of the House of Representatives (September 20, 1977).

brokerage, and dealing in bonds should come under the direct regulation of a federal securities agency or whether they should remain under the jurisdiction of the Department of Finance is another question. In the United States even the SEC has recommended that all regulation of banks remain with the bank regulatory authorities rather than with the SEC. And this recommendation was made despite evidence that the banking authorities had never been particularly interested in the kind of regulation that is appropriate to a securities business.

The trust companies present still a different case. Some are provincially incorporated and some come under federal regulation. So far no serious conflicts seem to have emerged between trust company legislation and the regulation of the securities markets and the securities industry.

A difficult policy choice, one that has appeared before in this paper, is the choice between open competition and regulation. On the one hand, substantial participation by banks in the securities industry has a good deal to offer to the efficiency of Canadian capital markets and to economic growth. Banks in Canada have been successful in underwriting, in providing a secondary bond market, and in furnishing incidental brokerage services to customers. They have both the talent and the widespread branch network that should be able to provide more efficiently than anyone else a number of securities market services. We have evidence from the United States that the participation of commercial banks in underwriting tends to make that underwriting more efficient and reduces the cost to issuers.

On the other hand, the Canadian banking industry is highly concentrated so there may be dangers in giving it free rein in the securities market. The trend in recent years in the United States has clearly been toward greater competition and a lowering of barriers that have divided the activities of different kinds of institutions. The same policy is evidenced in the proposed amendments to the Canadian Bank Act, although Canada has not gone nearly as far as the United States.

There is already, of course, a fair degree of concentration in the Canadian securities industry, particularly in underwriting, and there is a question whether the danger of concentrating underwriting in the hands of chartered banks is any greater than the danger of concentrating it in a few major investment dealers. The number of dominant underwriting investment dealers is not very different from the number of major chartered banks.

It would be much easier to reach some of these policy decisions if more information were available. In particular some information on the portfolio holdings of trust companies would be helpful.

The trust and agency accounts of these companies hold some $12 billion in Canadian equities and virtually nothing is known outside the trust companies themselves about these portfolios. There is probably no need to undertake the vast amount of reporting and data collection that has been implemented in the United States but some steps should be taken toward disclosure.

Chapter V
Institutions and Independent Individual Investors in the Stock Market

It is quite clear that in both Canada and the United States a substantial proportion of stock ownership and stock trading has shifted from independent individuals to institutions. The extent of the shift is discussed later in some detail but briefly the most recent data show individuals accounting for 49% of the value of public trading on the Toronto Stock Exchange and 31% on the New York Stock Exchange.

A. REASONS FOR CONCERN ABOUT INSTITUTIONALIZATION

The consequences of institutionalization are important and indeed critical to some basic policy choices among regulatory procedures and ways of structuring the stock market. Regulation and structure have developed over the years in the context of a stock market dominated by individual investors or, more precisely, by investors whose orders are generally for a modest number of shares. The stock exchange auction market and the fixed brokerage commission rates were devised to deal with individual trading. The regulatory system with its concern for investor protection and its allocation of functions among brokers, dealers, banks, trust companies and other financial institutions and intermediaries has evolved over the years to deal with a marketplace of individuals.

In recent years we have begun to find the regulatory system and the structure are not well suited to a market dominated by institutions. One policy course is to adapt the regulation to the market structure. Another is to reverse the institutionalization and try to restore an individual marketplace.

Canada is beginning to experience the contest between these two policies, a contest that began in the United States in the late 1960s and that is still far from over, although the final outcome is probably quite foreseeable. The controversy over fixed commission rates beginning in 1968 was the first stage of the contest. The fixed rates on the New York Stock Exchange were simply quite unreasonable for large institutional transactions. At the same

time and for the same reason a struggle broke out over admission of financial institutions to stock exchange membership that would have given them direct access to trading without paying the fixed commission rates. The stock exchange membership fought long and hard for their fixed rates and against institutional memberships, largely on the ground that it was crucial for the health of the marketplace to encourage and service the trading of individuals even if this meant rules that imposed expense and inconvenience on institutions. The commission rate dispute was resolved with the unfixing of rates charged to the public on May 1, 1975, and the unfixing of intermember rates a year later. The institutional membership issue is still unresolved.

The contest continues, in terms of market structure. The role of the market-maker – the specialist on the New York Stock Exchange and the dealer market-maker in the over-the-counter market and the third market (the U.S. over-the-counter market in listed stocks) – is a current focal point in the argument over the proper form of a national market system. The basic issue is whether the system is to be geared to the many small trades of individuals or to the large transactions of institutions. West and Tinic said in 1974: "The growth of the institutions and the concomitant decline in the relative importance of individual investors have created virtually insurmountable problems for the traditional continuous auction market."[408] They cited data from the SEC *Institutional Investor Report* as evidence that specialist participation decreases with increasing size of institutional transactions.[409] They concluded that the marketplace of the future will feature enhanced competition in the auction market and a close tie between the auction market and a dealer or even institution-to-institution market. That is, the present exchange market with its specialists will become more competitive and will be linked more closely to the third and fourth markets (the dealer market in listed stocks and the institution-to-institution market).

In Canada the Ontario Securities Commission held hearings in 1976 on the fixed commission rate structure of the Toronto Stock Exchange and heard most of the arguments that had been offered to the Securities and Exchange Commission eight years before. The Canadian institutions, however, were less inclined than

408 West & Tinic, *Institutionalization: Its Impact on the Provision of Marketability Services and the Individual Investor*, [1974] J. Contemporary Bus. 25, 30 (winter).

409 The specialist's role is discussed in *Williamson, Capital Markets*, ch. II. A recent review of the literature and report on empirical work concludes, however, that specialists could be making money on block positioning; *see* F. Reilly & J. Nielson, Specialists and Large Block Trades on the NYSE (Research Paper No. 61, College of Commerce and Industry, University of Wyoming, January 1975).

American institutions had been to press for unfixed rates (just as they had shown less interest in a third market and no interest in institutional membership). The OSC, with two dissents, decided to let the commission rates remain fixed but with a directive to the TSE to come up with an improved set of rates. A new set of fixed rates was approved in 1977.[410]

The market-making function has not yet become a burning issue in Canada, although it is a troublesome one and may call for hard choices if and when the Canada-Wide Trading System is implemented.

Legislators in both Canada and the United States are faced with controversy over the appropriate powers of financial institutions and intermediaries. In Canada revisions to the Bank Act involve questions of bank participation in securities markets and the consequences in terms of the quality of those markets in serving individuals and institutions. At the same time Ontario is still debating amendments to the Ontario Securities Act that would alter the extent of regulation over securities-related activities of financial institutions and the attractiveness of stock markets to institutions and individuals.

So it makes a great deal of difference in planning or modifying a regulatory scheme whether we accept institutionalization of the stock market and work out a system that serves institutions well or whether we try to shift stock ownership and trading back to individuals, perhaps in part by discouraging or penalizing or simply limiting institutional ownership or trading.

B. EFFECTS ON THE QUALITY OF SECONDARY STOCK MARKETS

The economic growth of the nation depends on primary financing – the flow of savings into corporation and government treasuries for investment in real productive assets. But the secondary market – the market in which owners of securities trade them back and forth – is indirectly important because it facilitates a primary market and offers some independent benefits. So we begin with an examination of the *effects* of institutional and individual trading in the secondary market, where they are most obvious, and then turn to consider the primary market.

1. *Opinion on the Effects of Institutional Trading*

One can turn to two sources of information on these effects. The first is a vast body of opinion, conjecture, hypothesis and

410 Commission rates are discussed in ch. III *supra*

logical reasoning. The second represents empirical research and is quite small.

In 1973, a year of sharp stock market decline, a number of witnesses appeared before the United States Senate Subcommittee on Financial Markets, chaired by Senator Bentsen, to testify on the effects of institutional investment activity.[411] The witnesses could be divided essentially into two groups. One group came from the stock exchanges and from brokerage firms apprehensive about the power of institutions to either drive down commission rates or take over the brokerage function themselves, as well as from corporations whose executives were dismayed at the declining prices of their stocks and saw institutions as the villains. The other group came, of course, from the institutions.

Witness after witness reaffirmed the importance of individual participation in the securities markets. A decline in the number of individual shareholders in the United States was deplored, as was the decline in the percentage of shares owned by individuals and in the percentage of trading on the New York Stock Exchange carried on by individuals. At the same time some mention was made of the increasing dollar value of shares held and traded by individuals. It never became clear in the hearings which statistics were the most significant: dollar value of individual holdings, dollar value of individual trading, number of individual shareholders or traders, or percentage of stock ownership or trading by individuals. No specific evidence was ever presented to demonstrate the contribution made by individual ownership of stocks or trading of stocks to the quality of the securities markets.

James J. Needham, chairman of the board of the New York Stock Exchange, listed a number of benefits one might expect to flow from individual trading: the provision of breadth to trading in many stocks that are not generally purchased by institutions, liquidity that comes from many orders from individuals, and the supply of new equity capital to small and growing companies. And he stressed the advantage of widespread ownership by individual investors in reducing the danger of undue concentration of power in the hands of large institutions.[412]

Needham and others urged the apparent disadvantages of substantial institutional trading, again with almost no evidence of specific harmful effects. The third market and the growth of the regional stock exchanges were substantially due to institutional investors and these markets fragmented the primary market (the

411 *Financial Markets: Hearings before Subcomm. on Financial Markets of the Senate Comm. on Finance*, 93d Cong., 1st Sess., pts. 1, 2 and app. (July and September 1973).

412 *Id.* pt. 1, at 106-07, 127.

New York Stock Exchange) to the apparent disadvantage of individual investors.[413] He and other witnesses claimed that institutions generally acquire stock positions slowly over time but sometimes "dump" their positions in a very short period of time driving down prices to the disadvantage of individuals. A number of specific cases of apparent "dumping" by institutions were described but it was clear that in many if not all of the cases unexpected bad news had led to a rapid decline in price and there was no evidence that institutions drove the prices down further than they should have gone.[414]

The cry of the corporate executives was essentially that the stocks of their corporations were undervalued and that something should be done to force or at least induce investors to put more money into those stocks and bid the prices up.[415] There was a suggestion that institutions had conspired to ignore the stocks of less than first-rate quality. The practical consequences of depressed stock prices, it was explained, are an inability or unwillingness to raise more equity capital for growth, disappointment on the part of recipients of stock options, and attractive opportunities for foreigners to purchase U.S. corporations because they place a higher value on the stocks than do United States investors.[416]

In the course of the hearings a number of interesting suggestions were made for the encouragement of individual ownership and trading of stocks and the discouragement of institutional ownership and trading, particularly in the heavily capitalized corporations. The proposals with respect to institutions had to do with limiting stock ownership and the speed of sale of equities by institutions. (No witness suggested that there should be any limitations on the speed of purchase by an institution.) Among the proposals were a statutory limit on the percentage of stock outstanding of any one corporation that might be held by an institutional investor;[417] a limit on the fraction of the outstanding shares of any particular corporation that an institution would be permitted to sell in a thirty-day period;[418] and increased commission rates to discourage institutions from selling stock.[419] It was also suggested that an improved options market may provide opportunities for institutions to dispose of holdings with less impact on the market through the writing of covered call options.[420]

413 *Id.* at 129.
414 *Id.* at 158, 187, 225–29.
415 *Id.* at 195.
416 *Id.* at 165–67.
417 *Id.* at 6–7, 159.
418 *Id.* at 142–43, 189.
419 *Id.* at 163.
420 *Id.* at 130.

Witnesses from institutions by and large took refuge in supporting increased disclosure of institutional holdings and trading activities pointing out that they have a substantial fiduciary obligation to do the best for their beneficiaries and in some cases arguing that they were making increased efforts to invest in medium-sized if not small companies.[421]

In testimony presented before a congressional committee in 1976, Professor Roy A. Schotland offered an array of statistics on the percentage of total trading in a number of common stocks accounted for by Morgan Guaranty Trust from 1973 through 1975 and from these figures drew the conclusion that institutional trading, particularly the trading of Morgan Guaranty Trust and a few other very large trust departments, must have a significant and unfortunate effect on stock prices.[422] He offered no evidence to this effect, simply stating that "it defies belief" that the trading would not have at least significant impact and asking "can anyone doubt" that the trading of Morgan is a price-setter?[423] Schotland also argued that large institutions like Morgan are able to create their own superior investment performance records by accounting for a substantial proportion of trading in a number of stocks. He did not explain how it is possible for an institution to bid up the price of a stock beyond any reasonable value and to continue to raise it year after year in order to maintain a superior long-run performance record.[424]

Schotland did not recommend any direct limitations on trading, but he did recommend that a trust department should not be permitted to hold in the aggregate more than 5% of the outstanding shares of any single large corporation.[425]

Professor David W. Miller prepared for Morgan Guaranty Trust, in the summer of 1977, an analysis of Morgan's trading that refuted virtually all of Schotland's conclusions. Much of the testimony in the hearings referred to above was concerned with the "two-tier" market, a phenomenon much discussed in the early 1970s, particularly in 1973 when the stock market had declined but the "top tier" had held up rather well. The theory was that the top tier consisted of the favourites of institutional investors who sup-

421 *Id.* at 61-63, 81-82.

422 Staff of House Comm. on Banking, Currency and Housing, 94th Cong., 1st Sess., 1 FINE: Financial Institutions and the Nation's Economy, Compendium of Papers Prepared for the FINE Study 211-27 (1975).

423 *Id.* at 212, 214.

424 *Id.* at 219.

425 *Id.* at 221.

ported the prices of these stocks and thereby achieved superior investment performances. The lower tier consisted of stocks that did not have institutional support and therefore declined in price.[426] The theory appealed chiefly to those who saw something diabolical in institutional concentration of investments. With the decline of even the top tier in 1974 and the recovery of many lower tier stocks in 1975 and 1976 the theory was temporarily shelved. And some evidence has been brought forward to show that there have always been "favourites" with changes from time to time in the stocks included in this category.[427]

An interesting variation on the two-tier theory was published in 1975. Frank Reilly suggested that a marketability need, rather than performance manipulation, will inevitably lead institutions to favour a narrow list of stocks.[428] He suggested that of some 9,500 corporations in the United States with publicly traded stock, fewer than 400 have a market value of $400 million and therefore offer the marketability needed by an institution with $1 billion or more to invest in equities (as is the case for the top seventy or so institutional investors). A middle tier, consisting of corporations with a market value from $200 to $400 million, would offer sufficient marketability for most institutions and large individual investors. Reilly estimated that this tier would include about 300 stocks. The bottom tier, then, would contain some 8,800 stocks.

The argument based on marketability is certainly more plausible than one based on performance strategies but there is evidence that casts some doubt on it. In responding to a questionnaire from the Senate Finance Committee in 1976 some of the twenty-nine largest bank trust departments in the United States described investments in companies in Reilly's middle and bottom tier. Morgan Guaranty Trust, which manages over $9 billion of common stocks in employee benefit funds alone, reported a special situation-equities commingled fund with half a billion dollars invested in the stocks of 190 companies with capitalizations below $100 million. A second commingled fund had another half billion dollars invested in 117 companies with capitalizations between $100 million and $500 million.[429] First National City Bank, with

426 The Miller analysis was transmitted to Senator Lloyd Bentsen, chairman of the Subcommittee on Private Pension Plans and Employee Fringe Benefits, of the Senate Finance Committee, by Harrison V. Smith of Morgan Guaranty Trust on August 4, 1977.

427 Blume, *Two Tiers - But How Many Decisions?*, 2 J. Portfolio Management 5 (Spring 1976).

428 Reilly, *A Three-Tier Stock Market and Corporate Finance*, 4 Financial Management 7 (Autumn 1975).

429 Subcomm. on Financial Markets, *supra* note 230, at 6.

over $4 billion in equities in employee benefit funds, also reported two commingled funds, one with half a billion dollars apparently aimed at medium-sized and large companies and a smaller fund directed to small, expanding companies.[430] Harris Trust and Savings (over $1 billion in employee benefit fund common stocks) also reported a collective fund with $103 million invested in seventy small companies,[431] and Crocker National (over $900 million in employee benefit fund equities) referred to investments in companies with market capitalizations as low as $25 million.[432]

All of this does not disprove the likelihood that there will be continued institutional *preferences* following Reilly's logic. But it does seem clear that the largest institutions can accommodate substantial holdings of middle and lower tier stocks. Indeed, many of the responses to the questionnaire indicated increasing diversification in common stock holdings and one might argue that the largest institutional investors are in the best position to assemble thoroughly diversified portfolios of small and relatively high risk companies. And as we shall see, this ability may be important to the primary financing of these companies.

In Canada, too, it has been argued that there is a two-tier market and we do have some evidence of the extent to which institutions, in contrast to individuals, concentrate their trading in "top traded" stocks. The Toronto Stock Exchange has reported as part of the findings of the Revenue and Market Analysis Study (RAMA) that for the quarter April–June 1976 institutions accounted for 43.9% of the dollar value of all trading on the exchange and 55.3% of trading in the "top traders".[433] (The "top traders" were the one hundred stocks most traded in 1974. By 1976 this list had declined to about ninety-five stocks.) However, as of the end of 1975 this set of stocks accounted for 66% of the market value of Canadian stocks on the TSE ($34.0 billion of $51.7 billion),[434] and in 1975 trading in these stocks constituted 66% of total trading in Canadian stocks on the exchange ($2.60 billion of $3.96 billion).[435] So it appears that at least for 1975 trading in the "top traders" was proportional to market value outstanding and small and medium-sized companies do not appear to have been neglected in the secondary market.

430 *Id.* at 10, 11.
431 *Id.* at 27.
432 *Id.* at 46.
433 Toronto Stock Exchange, *RAMA Results for the April–June 1976 Quarter*, Notice to Members No. 1387 (October 21, 1976).
434 The numbers were computed from a list of values for 1975 of all TSE stocks. The values of all U.S. stocks were eliminated from the total.
435 The numbers were computed from a list of trading values for 1975 of all TSE stocks. Trading in U.S. stocks was eliminated from the total.

Table 54
Distribution of Equity Agency Trading between Top Traded Stocks and Other Stocks on the Toronto Stock Exchange

April–June 1976

	Institutions	Individuals	Inter-mediaries	Total
Number of orders				
Top traded stocks	6.01%	17.27%	1.26%	24.54%
Other stocks	8.84	61.30	5.32	75.46
Dollar value				
Top traded stocks	25.69	18.26	2.52	46.47
Other stocks	18.19	31.33	4.01	53.53
Number of shares				
Top traded stocks	7.99	7.07	0.87	15.93
Other stocks	11.66	64.09	8.32	84.07
Commissions				
Top traded stocks	18.29	19.98	1.58	39.85
Other stocks	15.49	41.84	2.82	60.15

Source: Toronto Stock Exchange, *RAMA Study*, Notice to Members No. 1387, table 6, October 21, 1976.

2. *Empirical Testing*

A number of empirical studies have explored the impact of institutional trading on the quality of the stock market.[436] One of the first was a part of the *Institutional Investor Report* by the SEC published in 1971, two years before the hearings discussed above. In its overall conclusions, the SEC reported:

> "The preponderance of data collected by the Study on monthly net institutional trade imbalances, on institutional position changes, on block trades and on day-to-day price changes analyzed in Chapters X, XI, XII indicate that institutional trading in the aggregate is related to or coincident with relatively few of the large price changes that occur in the securities market....Other analyses of random large position changes by institutions indicate that, even on an inter-day basis, institutional trading appeared to offset price movements about as frequently as it appeared to contribute to them. Furthermore, from the data on market-makers it appears that during stock months in which institutions were more active, large close-to-close price changes were less frequent....Thus, the Study has not discovered any basis in terms of price stability for imposing generalized limitations on the volume of institutional trading or on the size of institutional transactions."[437]

In 1977 Frank Reilly reported empirical testing using the SEC statistics for stock transactions of major financial institutions annually for 1962 to 1974 and quarterly for 1964 to 1975. He found no evidence of a strong positive relationship between institutional trading and stock price volatility.[438] Other research has found a *negative* relation between block trading (characteristic of institutions) and price volatility.[439]

There have been studies specifically of mutual fund investment behaviour reporting the effects on the market of trading by the funds. In 1970 Friend, Blume and Crockett reported their research on mutual fund investment performance and the appar-

436 The Quebec Securities Commission Task Force cited a number of articles in reaching its conclusion that there is no proof that the leading role played by institutions in European markets has reduced their efficiency; QSC Task Force, *supra* note 144, at 19-20.

437 Institutional Investor Report, Summary Volume, at xxi.

438 Reilly, *Institutions on Trial: Not Guilty!*, 3 J. Portfolio Management 5 (winter 1977).

439 Grier & Albin, *Nonrandom Price Charges in Association with Trading Large Blocks*, 46 J. Bus. 425 (July 1973); and F. Reilly, Block Trades and Stock Price Volatility (October 1975) (Faculty Working Paper No. 279, University of Illinois).

ent impact of mutual fund purchases and sales on the stock market.[440] They found that in the late 1950s through most of the 1960s stock buying by mutual funds did seem to accompany a substantial price rise in the stocks purchased, while price declines accompanied stock sales. This pattern could have been due to the ability of mutual fund managers to correctly predict stock price movements and to make use of their predictions or it could have been due simply to the effect on prices of substantial institutional purchases and sales. The authors had already uncovered evidence casting suspicion on the ability of managers to profit from evaluations of common stocks any more than anyone else. And some features of the price performance, notably the recovery of stock prices after a decline that accompanied mutual fund sales, suggested that it was the trading rather than the correct prediction of the market that accounted for the results observed. Overall, however, these three authors were unable to conclude that institutional trading had any significant impact on the efficiency of the stock market.

John Evans reported in a 1975 paper his analysis of the impact of mutual fund trading on the Canadian stock market.[441] He concluded that mutual fund trading over the period from 1965 to 1971 did exert substantial price pressure on the stocks of small companies (those with fewer than ten million shares outstanding). Substantial buying by mutual funds appeared to push up stock prices which subsequently declined as the mutual fund buying slowed or ceased. Selling by mutual funds appeared to push down stock prices and these prices tended not to recover subsequently. Evans attributed this price behaviour to a two-tier market effect with mutual funds simply disposing of their holdings in some small companies and leaving the stocks to languish in a non-institutional market.

An analysis of mutual funds in Spain concluded that funds had increased the efficiency of the Spanish stock market. Mutual funds are the only financial institutions participating in the Spanish stock market and during the period preceding 1966, when funds began operating, the market was noticeably less efficient than in the post-1966 period.[442] It seems likely, however, that it was not the trading activities of the funds but their demands for hitherto unavailable corporate information that led to a better market. This conclusion is not to deprecate the usefulness of insti-

440 I. Friend, M. Blume & J. Crockett, Mutual Funds and Other Institutional Investors: A New Perspective (1970).

441 J. Evans, Mutual Fund Trading and the Efficiency of Canadian Equity Markets (1975) (Working Paper No. 214, Faculty of Commerce and Business Administration, University of British Columbia).

442 Palacios, *The Stock Market in Spain: Tests of Efficiency and Capital Market Theory.*

tutional participation in the market; it means that institutional investors can contribute to market quality by forcing better disclosure than individual investors are able to obtain.

There have been a few studies of the effects of large transactions – the kind one would expect for institutions – on stock prices. If there is an impact on the price of a stock, it could be due to price pressure or to information. That is, it may take a price reduction to sell a large block or one may have to pay a premium to buy a large one, or the person initiating a large trade may have inside information and the price adjustment accompanying the trade will simply reflect the information. Some of these studies were reviewed in a paper by Reilly and Drzycimski in 1975.[443]

In a study of the effects of 7,000 block trades (over $1 million each) on the New York Stock Exchange in 1968 and 1969, Kraus and Stoll concluded that for block trades initiated by buyers there were upward adjustments of price due to information and a true increase in the value of the stock.[444] They concluded, however, that most block trades are originated by sellers and that these showed some price pressure effects.[445] Prices would be depressed by the sale, but would recover, usually by about the magnitude of one commission, by the end of the day. They also found that block trades did not lead to increased price volatility. Indeed, another study concluded that block trades reduced price variability.[446]

Analysis has also been carried out on parallel trading by institutions – trading in which several institutions are simultaneously buying or selling. Presumably parallel trading can be significant only if there are individuals on the other side of the transaction – to buy when institutions are selling and to sell when institutions are buying. Parallel trading conflicts with the concept of a tiered market with institutions operating in one tier and individuals in another. Kraus and Stoll, using data gathered for the SEC *Institutional Investor Report* for 1968–69, found that institutions tend to be active in the same stock at the same time but not necessarily on the same side.[447] Banks and investment companies showed evidence of parallel trading in heavily traded NYSE stocks but the two kinds of institution were generally on opposite sides of the market. Bank trust departments were buying

443 F. Reilly & E. Drzycimski, Institutional Trading and Stock Price Volatility (January 1975) (Research Paper No. 60, College of Commerce and Industry, University of Wyoming).

444 Kraus & Stoll, *Price Impacts of Block Trading on the New York Stock Exchange*, 27 J. Fin. 569 (June 1972).

445 1,199 trades were classified as seller initiated and 366 as buyer initiated.

446 Grier & Albin, *supra* note 439.

447 Kraus & Stoll, *Parallel Trading by Institutional Investors*, 7 J. Fin. & Quantitative Analysis 2107 (December 1972).

when investment companies were selling and vice versa. On the whole institutions tended to offset each other's trading more than one would expect from pure chance. There were, of course, instances of parallel trading and an imbalance of institutional supply and demand which led to price pressure effects.[448]

An interesting analysis of the effect of large trades in the Canadian stock market was reported in 1975. Nicholas Close used data on secondary offerings and transactions large enough to qualify for volume discounts on brokerage on the Toronto and Montreal Stock Exchanges in 1970 and 1971. He was able to classify accurately the trades as buyer or seller initiated because the classification was noted on the volume discount reports from brokers.[449] The data covered 1,541 buyer-initiated and 1,092 seller-initiated transactions. The price effect of the buys was described as:

> "For buys, days −15 to −1 (the 15 days preceding the trade) indicate that prices preceding block purchases tend to be slightly higher than at any other time in this first period immediately before the block. Days 0 to +4 – the five-day period of actual trading – feature rapid price appreciation of about 1.8 percent, most of which occurs on day 0. From +4 to +15 the index does not drop, indicating that the price changes associated with block purchases are "permanent" in nature, supporting the information effect explanation.
>
> "For sales, the most striking feature is the lack of any impact. Prices are relatively strong from day −15 to −1. Then there is a drop of about 0.5 percent during days 0 and +1. After a seven-day period of no movement, prices tend to recover and by day +15 they are slightly higher than on day −1. These results best support the substitution hypothesis, which predicts little or no impact."[450]

Price impact was found not to be related to the value of a trade which tends to refute a hypothesis of price pressure effects. Perhaps of more interest in the Canadian context where the volume discount is available for aggregate trades over five consecutive trading days, the price impact of sells (which we have seen was virtually non-existent on average) did not differ as the trade was spread over one to five days. But for buys, spreading the trade over

448 Specifically, parallel buying in a $50 stock that produces a $5 million excess of institutional purchases over sales in a month could be expected to bring about a 75¢ increase in the stock price that month with a 53¢ reversal the next month.

449 Close, *Price Reaction to Large Transactions in the Canadian Equity Markets*, 31 Fin. Analysts J. 50 (November–December 1975).

450 *Id.* at 51, 53.

several days did drive up the price temporarily – there was a price pressure effect.

Some further interesting results came from separating the trades in stocks with a high institutional following from those with a low institutional following. For the former (the top ten) there was almost no price impact for buys and for sales a steady price decrease up to and including the trade days, steadying at day +8 at about a 2% discount.

For the stocks with a low institutional following (the bottom fifty), the buys showed a substantial and mostly lasting price increase suggesting information effects. The sells were *also* associated with a permanent price increase of about 6%. Close's explanation is that a price increase triggers block sales and that the sales simply halt the increase. In any case, there seems to be little in the way of price pressure effects, for buys or sells, for institutional or non-institutional stocks.

Further tests of the impact of institutional trading have considered correlation between volatility of stock prices and institutional activity. Reilly and Drzycimski found an increase in volatility from 1965–67 to 1970–73, a period of increasing institutional share of trading.[451] But they also analyzed the variability in a number of economic variables and concluded that "several of these could explain the increase in stock price volatility distinct from any increase caused by institutional trading".[452]

3. *Comparison of Institutional and Individual Trading*

There have been very few studies of individual investor behaviour, largely because it is so difficult to obtain data on individual holdings and trading. One particularly interesting study on the relative merits of institutional and individual trading took the form of a test involving New York listed stocks, of the Capital Asset Pricing Model. A brief description of the model is necessary before reporting the results of the research. According to the model, in an efficient stock market investors will anticipate a rate of return on a particular stock that is proportional to its "market risk" but independent of its "unique risk". The perceived total risk in a stock is thought of as consisting of these two components. The market risk simply reflects the fact that all stocks move more or less with the stock market; some respond sharply to market moves and have a high market risk; others respond less and have a low market risk. But the movement of the

451 F. Reilly & E. Drzycimski, *supra* note 443.
452 *Id.* at 20.

market as a whole does not explain all of the movement in individual stock prices; so each stock has its own unique risk. An investor can anticipate that a stock will move to some extent with the market and he can estimate the market risk. He can also anticipate that there will be independent movement in the price of the stock arising from factors affecting that stock uniquely. And he can make an estimate of the unique risk. The capital asset pricing model assumes that an investor will take risks only if he expects to be paid for them. Hence the greater the expected risk, the greater the expected return the investor will demand when he purchases a stock. But the model also assumes that investors are capable of putting together fully diversified portfolios. And in a fully diversified portfolio the unique risks of individual stocks will cancel out. So for an investor who holds a fully diversified portfolio, the only risk that matters is the market risk. The prices of securities should be such that they offer an expected rate of return that is just proportional to market risk. For an investor whose portfolio is *not* fully diversified, the unique risk in the stocks he owns will *not* be diversified away and he will hope to be compensated for this risk in the expected rate of return on his stocks. If all the investors in a market have poorly diversified portfolios, one would expect securities to be priced in such a way that the expected return on a stock will be proportional to the total risk in that stock, the market risk plus the unique risk.

Now if it turns out that institutional investors tend to hold fully diversified portfolios while individual investors tend to hold poorly diversified portfolios and if there is a class of stocks that might be called "institutional" and another class of stocks that are predominantly held by individuals, then one might anticipate that the institutional stocks will be priced in such a way that their expected return is proportional to their market risk, while the non-institutional stocks will be priced in such a way that their expected return is proportional to their total risk.

Barnea and Logue tested this hypothesis for New York Stock Exchange stocks over the period July 1966 through June 1971.[453] The data used were for 160 stocks, fifty of which were treated as institutional stocks because institutions held anywhere from 20% to 50% of total shares outstanding. The remaining 110 stocks were regarded as non-institutional. Correlations between return and market and unique risk verified the hypothesis put forward above. For the institutional stocks expected return was apparently proportional to market risk, while for the non-institutional stocks

453 A. Barnea & D. Logue, Diversification Costs and Market Equilibrium (unpublished paper, 1975)

expected return was proportional to the sum of market and unique risk. The implications of these results are quite important because they mean that the cost of equity to corporations that are held by institutions is lower than the cost to corporations that are not held by institutions. And this result has nothing to do with the possibility that institutions are deliberately bidding up the prices of their favourites in order to achieve superior performance. It simply has to do with the likelihood that institutions achieve fully diversified portfolios, while individual investors do not.

There does not appear to have been any directly corresponding research on the stock market in Canada. Two authors who examined stocks listed on the Toronto Stock Exchange over the period from 1959 to 1971 concluded that expected returns for the stocks were not proportional to market risk and were presumably dependent on the sum of market and unique risk. However, they made no attempt to distinguish between institutional and non-institutional stocks.[454]

C. EFFECTS ON THE QUALITY OF THE PRIMARY STOCK MARKET

So far as economic activity is concerned the primary securities markets, rather than secondary markets, are what matter. It is by way of primary markets that new capital is supplied to business and government for investment in real, productive assets.

It is generally assumed that the quality of primary markets – the success with which governments and businesses can raise capital at reasonable cost – is closely related to the quality of secondary markets, although there appears to be no empirical research on this point. At the least the secondary market serves to price securities, and we have seen that there is evidence that stocks held by institutions are priced to offer a lower rate of return than stocks not held by institutions.

Much of the alarm expressed over the institutionalization of the secondary market has concerned the concentration of institutional investment in the largest companies. A number of the submissions to the Ontario Securities Commission in the summer of 1976 on the subject of fixed minimum brokerage rates commented that the existence of active secondary markets in a company's stock is critical in enabling that company to raise new equity capital and that institutions are generally not interested in the stock of small and medium-sized companies. Against this we have seen evidence that some very large bank trust departments in the

454 Findlay & Danan, *A Free Lunch on the Toronto Stock Exchange*, 6 J. Bus. Admin. 31 (spring 1975).

United States have formed pooled funds to invest in small and medium-sized companies.

D. THE EXTENT OF INSTITUTIONALIZATION

The submissions to the Ontario Securities Commission in the summer of 1976 on the subject of fixed minimum commission rates reflected sharp disagreement over the extent to which the Canadian equity market has actually been institutionalized. The Montreal Stock Exchange, in a report by P. Lortie, presented statistics suggesting extraordinary concentration of equity ownership and trading by Canadian institutions, particularly a few Canadian trust companies.[455] Many of the other submissions accepted the statistics presented in this report and argued from them, generally expressing great concern over institutional concentration. Some submissions, however, challenged the Lortie statistics, arguing that the threat is not nearly as great as he suggested.[456] The *Quebec Securities Commission Task Force Report* also disagreed with Lortie.[457] It is extraordinarily difficult to calculate the percentage ownership by different kinds of investors of the equities *available for trading* in the Canadian marketplace. It is a good deal easier to identify the proportion of the trading itself that is conducted by different classes of investors. Table 55 compares institutional and individual stock trading in the United States[458] and Canada.[459] The table indicates that so far as equity trading is concerned individuals play a much greater role in the Canadian listed stock market than they do in the United States listed stock market. Table 56 shows some institutionalization of the Canadian market over time but also a leveling off of this trend. (The same leveling off has been observed for the New York Stock Exchange.)

Trust companies constitute a special case. The submissions to the OSC, especially those of the stock exchanges, stressed the extraordinary concentration of stock ownership and trading in Canadian trust companies. This concentration was cited as a factor differentiating Canadian from United States securities markets and suggesting special dangers to Canadian markets should trust

455 P. Lortie, The Case for Fixed Commission Rates in Canada, (April 1975) (report prepared for the Montreal Stock Exchange). This report was prepared in response to a request by the Quebec Securities Commission for justification of fixed rates.

456 *See* especially The Royal Trust Co., Comments by The Royal Trust Co. on a Brief by the Montreal Stock Exchange entitled, The Case for Fixed Commission Rates in Canada (March, 1976).

457 Quebec Securities Commission Task Force, *supra* note 144, at 21-23.

458 New York Stock Exchange, Public Transaction Study, 1976 (January 1977).

459 Toronto Stock Exchange, *RAMA Study Reports on 12 Months of Agency Trading* Notice to Members No. 1370 (August 17, 1976).

Table 55
Institutional and Individual Stock Trading, the United States (NYSE Members) and Canada (TSE Members)

1976

	Individuals	Institutions	Inter-mediaries[a]	Members
All trading in the U.S.[b]				
Volume in shares	33%	45%		22%
Value of shares traded	23	55		22
Public trading in the U.S.[b]				
Volume in shares	43	57		
Value of shares traded	30	70		
Canada[c]				
Volume in orders	77	14	8	
Volume in shares	70	20	10	
Value of shares traded	49	43	8	

a. Intermediaries are securities firms other than member firms.
b. First quarter, 1976.
c. 12 months to March 31, 1976.
Source: *See* notes 458 and 459 *supra*.

Table 56
Agency Business Completed by Toronto Stock Exchange Members, Based on Value of Trading

1965–75

	Individuals	Institutions	Intermediaries
1965	54.6%	27.3%	18.1%
1968	54.1	33.5	12.4
1970	45.9	41.3	12.8
1975	47.3	43.9	8.8

Source: Toronto Stock Exchange, Notice to Members No. 1344, April 14, 1976.

companies be free to use their full strength in bargaining over commission rates.

The Toronto Stock Exchange *RAMA Study* reporting trading over the twelve months ending in March 1976 showed trust companies accounting for 12% of all TSE trading.[460] The 1975 *Report of the Registrar of Loan and Trust Corporations for the Province of Ontario* showed trust company estate, trust and agency holdings of common stocks at $12,104 million as of the end of 1975.[461] On the same date the value of all Canadian stocks listed on the TSE was $51,566 million. Trading on the TSE in 1975 was about 70% of trading on all exchanges in Canada and if we assume that TSE listings were worth at least 70% of total listings, then trust company stock holdings were at least 16% of total listed stocks.[462] We can at least say they were between 16% and 23%.[463]

In the U.S., 1974 statistics for bank trust departments show them holding about 21% of all common and preferred stock in trust and agency accounts.[464] So in the aggregate, concentration of holdings in trust departments does not seem very different as between the two countries.

Canadian trust company holdings are quite concentrated in a few companies. Royal Trust, with $5,541 million in stocks at the end of 1974, held 46% of all trust company stock holdings. The top five trust companies, in stock holdings, held 86% of all trust company holdings.[465] In the United States, Morgan Guaranty Trust held 5% of all bank trust assets and the top five banks in trust assets held 21%.[466] But there are 4,000 banks reporting trust assets in the United States and only thirty-eight trust companies reporting to the Ontario Registrar.

Some of the submissions to the OSC expressed the opinion that it is inevitable that independent investors will gradually abandon the stock market to institutions. And representatives of the secur-

460 Toronto Stock Exchange, *RAMA Study Reports on 12 Months of Agency Trading*, Notice to Members No. 1370 (August 17, 1976). The report covering April-June 1976, TSE, Notice to Members No. 1387 (October 21, 1976), showed 12.5% of trading accounted for by trust companies.

461 Report of the Registrar of Loan and Trust Corporations for the Province of Ontario, 1975, at 96 (1975).

462 (12,104/51,566) × 70% = 16%.

463 12,104/51,566 = 23%.

464 Trust assets of commercial banks at year end 1974 included $171,348 million in common and preferred stocks; Federal Deposit Insurance Corporation, Trust Assets of Insured Commercial Banks - 1974 (Washington, D.C. 1975). Salomon Brothers estimated total common and preferred stocks outstanding at that date of $810,000 million; Salomon Brothers, Supply and Demand for Credit in 1976 (1977) (both figures are market values.)

465 Report of the Registrar of Loan and Trust Corporations, *supra* note 461, at 96.

466 FDIC Report, *supra* note 464.

ities industry itself commented that for many individuals it makes more sense to purchase equities through a mutual fund than to purchase them independently through a broker. (Most of the theoretical literature supports this position simply because the diversification opportunities are so much greater in mutual funds than they are in an individual portfolio.) Some of the submissions indicated an expectation that a reduction in commission rates charged to independent investors or at least a reduction in the gap between the commission rates paid by institutions (on large trades) and those paid by independent investors would encourage the latter to trade more or to refrain from turning their savings over to institutions.[467] On the other hand, some of the submissions indicated that the level of commission rates probably has very little to do with the amount of trading done by individual investors.[468] Several submissions, including some supporting the existing fixed commission rate structure, accepted the proposition that under the existing system institutional trading was subsidizing the trading of independent investors.[469] At least one institution[470] stated that it was perfectly willing to pay the subsidy in order to obtain the benefits of the contribution of the independent investor to market liquidity.

Many of the submissions stressed the importance of services apart from low commission rates to independent investors. Many felt that providing research to independent investors has much to do with encouraging them to trade. Others felt that the number of registered representatives employed by brokerages in the aggregate has a lot to do with the extent of independent investor trading. These conclusions were generally part of an argument for a commission structure that tends to lead to large quantities of brokerage research and the employment of large numbers of registered representatives.

Almost all of the submissions predicted that abandoning fixed commission rates would lead to significant reductions in commission rates for institutions and very little reduction, if any, for independent investors. Some regarded this result as quite appropriate on the grounds that institutions were currently subsidizing independent investors. Others regarded it as entirely inappropri-

467 Several submissions called for lower commission rates and some said that reduced rates would lead to more trading by both individuals and institutions; *see e.g.* Lindsay, McKelvey & Co. Limited, submission to the OSC (May 1976). International Trust Co., submission to the OSC (April 30, 1976), predicted little increased institutional trading if rates were lowered but some increase in trading by individuals.

468 *See e.g.* Canada Permanent Trust Co., brief to the OSC (June 18, 1976).

469 *See e.g.* Vancouver Stock Exchange, brief to the OSC (June 1976); Toronto Stock Exchange, brief to the OSC (June 18, 1976).

470 *See* Manufacturers Life Insurance Co., brief to the OSC (June 28, 1976).

ate because of a perceived need for greater and not lesser participation by independent investors in the marketplace. It is interesting that none of the submissions considered the possibility that freely negotiated commissions might lead to arrangements providing for significantly reduced rates to independent investors. And yet precisely this result is reflected in the discount broker services available in 1977 in the United States.

The New York Stock Exchange in 1972 undertook some research on the importance of commission rates to individual stock investors.[471] In general, investors did not think an increase in rates would reduce their trading. Most did not even know what the rates were; many overestimated the rates; and a large majority had no quarrel with the rates.

In a series of United States hearings in 1976 the New York Stock Exchange contended that the pooling of small orders by commercial banks offering some type of brokerage service would further increase the percentage of volume in large orders and diminish the number of individual small orders which are necessary to provide depth and liquidity. The exchange added the comment that savings in commissions to individual investors brought about by this pooling will drain brokerage revenues from the securities firms that maintain the mechanism and regulation of the auction market.[472]

The rules of the Toronto Stock Exchange deny the benefits of quantity discounts to independent investment counsel who are able to pool transactions for a number of clients, and seem clearly aimed at denying reduced commission rates to investors who have chosen to remain independent. It is interesting that the Ontario Securities Commission endorsed the rule in question on the grounds that if independent investment counsel were able to pool the orders of their clients this might lead to excessive trading by those clients.[473] All of these rules seem to contradict most of the reasoning in the submissions supporting the need for greater independent investor trading.

We are left with conflicting opinions as to the effect of commission rates on individual trading. Those defending fixed rates have argued that high rates do not discourage trading and that there is no need to bring rates down. But then they have argued that competitive rates will draw business to the discounters and

471 A report on the results appears in *Financial Markets: Hearings before Subcomm. on Financial Markets, supra* note 41, pt. 1, at 121-22 (July 24-26, 1973).

472 *Financial Institutions: Hearings before Subcomm. on Financial Institutions, supra* note 200, pt. 3, at 2084 (December 1975, January 1976).

473 *In re* the Securities Act and the Toronto Stock Exchange and Fiscal Consultants Limited, [1974] OSC Bull. 139 (June).

away from firms offering traditional services. Implicit in this argument is a claim that the services are more valuable than commission savings but that individuals do not realize this.

It is hard to avoid the conclusion that only a free market, one in which brokers can compete freely on a price and service basis, will show what customers really want and what they are willing to pay. In such a market it may become evident that independent individual investors are not willing to pay what brokers must charge to stay in business or it may be that some brokers at least can offer very attractive rates to individuals and still operate profitably. They seem to be able to do so in the United States in 1978.

E. INSTITUTIONAL CONTROL OVER PORTFOLIO COMPANIES

Institutional control is an issue that has been of considerable concern to the United States Congress, as we have seen in connection with bank trust department holdings.[474] It has not been of as much concern in Canada, probably because almost nothing is known about trust company holdings. Other institutions do not seem to interfere much with the companies they hold.[475]

The argument has been advanced in Britain that institutions *should* play an active role. Dobbins and McRae reported that in the United Kingdom institutional investors own 45% of the common stock in quoted companies, and estimated that they will own 50% by 1977.[476] These two authors complained of unwillingness on the part of the institutions to act collectively in the use of their voting strength to influence corporate management. The British institutions appeared to behave much like the American institutions, occasionally exerting some private influence on management but generally simply selling their shares in cases of dissatisfaction. Dobbins and McRae predicted that there would be a change and a consequent improvement in the performance of British companies.

Four kinds of institutional shareholders -- insurance companies, pension funds, investment trust companies, and unit trusts – all have their own associations and in 1973 these associations formed the Institutional Shareholders' Committee with the objective of improving the efficiency of industrial and commercial

474 *See* ch. IV *supra*.

475 PORTER REPORT at 194 expressed the opinion that trust companies exert no dangerous influence over portfolio companies.

476 R. DOBBINS & T. MCRAE, INSTITUTIONAL SHAREHOLDERS AND CORPORATE MANAGEMENT (MCB Monograph 1975). And *see* Dobbins, *The Institutional Shareholder*, 2 MANAGERIAL FINANCE 341 (1976).

companies in Britain. The committee was formed with the support of the Bank of England and apparently the purpose was the concerted and effective use of voting power.

While Dobbins and McRae would like to see increasing institutional participation, they do point out that the interests of small shareholders may suffer and that some devices, perhaps the two-tier structure in use in some European countries, may be necessary to preserve true shareholder democracy. They say that the direct intervention by financial institutions in the decision-making processes of industrial organizations is commonplace in Europe. In Germany and France banks in particular have substantial equity holdings in individual companies and are the main source of external financing. While British banks are the main source of external finance for British industrial and commercial companies, they have simply not undertaken to influence company management as have German banks.

F. CONCLUSIONS AND POLICY IMPLICATIONS

A first policy choice for securities legislation or the rules of a regulatory commission has to do with the relative importance of institutions and individual investors. There is a widespread belief that institutional ownership of equities and trading should be restrained and that we should try to entice individuals back into the marketplace. But there appears to be little evidence to favour the contribution of individual trading over that of institutional trading. We have seen in chapter I the importance of institutional holdings of common stocks in Canada. If the institutionalization of portfolio holdings is inevitable, then it may be very damaging to the Canadian economy to attempt a regulatory structure that discourages institutions from buying common stocks.

But the argument remains that institutions favour the stocks of the large, well capitalized companies and that the small and medium-sized companies will not obtain the capital they need in a market dominated by institutions.

The economic case for the small and medium-sized companies has really never been carefully established. Whether the economy benefits more from a dollar of capital invested in a small company than from a dollar invested in a large company is still an open question. But there is such widespread opinion that noneconomic, social factors demand the encouragement of small business that perhaps we can ignore the purely economic question.

Next, there is the question whether small business is at a disadvantage in raising capital because of the structure of the capital marketplace. Many suppliers of capital to small business

claim that there is plenty of capital available but that few small businesses can justify an investment. Essentially, this amounts to a claim that investors, on the one hand, and small business owners, on the other hand, can rarely agree on the terms for financing. The investors, perceiving a high risk in a small business, demand a high expected rate of return and hence a low purchase price for stock. The owners, less impressed with the risk and more optimistic about success demand a high price. In a free market some bargains are struck but many businesses go unfinanced. No deficiency in the market structure, however, stands in the way of financing. There is simply a conflict among judgments and a failure to agree on financing terms.

But we have seen that there are three features of the marketplace that seem to put small companies at a disadvantage. One is the fact that an investor with a well diversified portfolio will find a small company less risky (or perhaps it would be more accurate to say less objectionable on the grounds of risk) than will an investor with a poorly diversified portfolio. Second, the indications are that institutions generally have well diversified portfolios, while individual investors tend to have poorly diversified portfolios. The result is that companies that rely on individuals to buy their stock have a higher cost of capital than those that can sell stock to institutions. Finally, we saw that institutions, for good reason, favour stocks that are marketable – stocks for which there is an active secondary market.

All of this suggests two avenues to reducing the cost and increasing the quantity of financing for small business. One would encourage individual investors to form well diversified portfolios; the other would enhance the marketability of stocks of small companies.

The first might mean bringing down transaction costs to the point where an investor with modest assets is able to spread those assets over a large number of stocks as cheaply as he can invest them in only a few stocks. This might be done by deliberately subsidizing the trading of individual investors. The second might mean easier stock exchange listings for small companies, bringing onto the exchange companies that do not qualify at present.

It is also possible that even for institutions with fully diversified portfolios unique risk is still a matter of concern. Institutions subject to a "prudent man" rule, if that rule is interpreted as requiring that each stock be evaluated on the basis of its total risk, may fear turning to what has hitherto been the non-institutional set of stocks. A change in standards of prudence reflecting the increased tolerance for unique risk in a stock that goes with diversification of a portfolio may be called for.

Whatever the policy choice, it is very difficult to make a case for discouraging institutional investment in stocks. And encouragement of individual investment is only one way and not necessarily the best to deal with structural obstacles to small company financing.

Appendix

This appendix reproduces the text of Chapter II from the Quebec Securities Commission Task Force Study of June, 1976: *Commission Rates in the Securities Industry*. It describes the rates in Canada and the United States, up to 1976, with particular emphasis on the spreads between rates in the two countries.

Chapter II
History and Characteristics of Commission Rates

Fixed commission rates for stock exchange transactions are not recent. In the United States fixed commissions go back to the so-called Buttonwood Tree Agreement of 1792, which provided

> "We, the Subscribers, Brokers for the Purchase and Sale of Public Stock, do hereby solemnly promise and pledge ourselves to each other, that we will not buy or sell from this day for any person whatsoever, any kind of Public Stock at a less rate than one-quarter percent (1/4%) Commission on the Specie value, and that we will give a preference to each other in our Negotiations . . ." (New York, May 17, 1792).

Until 1920 stock exchanges catered to a limited number of individuals. The general public was not involved to any significant extent in exchange trading in equity securities.

After the end of World War I, the public participated with increased frequency in exchange trading in equity securities and the stock market assumed unprecedented importance in the functioning of the economy.

The disastrous events of 1929 gave rise to a movement of reform in the United States which culminated in the enactment of the Act of 1934 and the regulatory authority given to the Securities and Exchange Commission (SEC).

After World War II, the public flocked into the securities markets, and financial institutions increasingly participated in those markets. These circumstances resulted in Congressional and SEC concern as to the adequacy of investor protection.

A first major study was conducted under the auspices of the SEC: "Special Study of Securities Markets", H.R. Doc. No. 95, 88th Congress, 1st Session (1963).

This study included, among other things, probably the first reasonably comprehensive analysis of the nature and structure of commission rates. It pointed out that:

a) the commission rate schedule covered a great variety of services performed by brokers in addition to the execution and clearance of transactions;

b) that the foregoing characteristic (a) of the rate structure induced service competition rather than price competition which resulted in complex and irrational distinctions between

permissible ancillary services and prohibited rebates of the minimum commission;

c) reciprocal arrangements were prevalent;

d) all the foregoing factors proved that the nature of the securities commission business was such that traditional principles of rate regulation could hardly be applied to it.

In January 1968, the New York Stock Exchange (NYSE) in response to the SEC's concern with respect to the operation of the commission rates schedules then in effect, submitted to the SEC a proposal for certain revisions in the structure of its commission rates schedule. The proposal provided for:

a) volume discounts;

b) economic access to the NYSE for non-member broker-dealers through a discount;

c) limited recognition of 'customer-directed give-ups'[1], and

d) prohibitions on procedures then used by institutions to recapture commissions.

Note: The SEC Release No. 8239, January 26, 1968, described in some detail the give-up and reciprocal business practices[2] which had been adopted in order to evade the fixed commission structure.

The NYSE proposal initiated the first major hearings with respect to rate structures[3] which were held from 1968 to 1971. For the first time the question was directly raised as to whether fixed rates of commission should be replaced by competitive rates. In December 1968, in the midst of the hearings, the NYSE and other exchanges adopted volume discounts and banned customer-directed give-ups.

The second major study was transmitted to the Congress by the SEC on March 19, 1971. It was entitled "Institutional Investor Study"[4] and covered the years 1969 and 1970. It was basically an economic study which included an examination of the impact of institutional investment on the securities markets. In a letter attached to the study report, the SEC concluded, among other things:

"The fixed minimum stock exchange commission on large orders had led to the growth of complex reciprocal relation-

1 The customer-directed give-up was a payment by the executing broker of a part of the minimum commission it was required to charge its customer, to other broker-dealers designated by the customer or his investment adviser. The amount of the payment was negotiated.

2 These are practices by which executing brokers provide compensation to other brokers at the direction of institutional investors, permitting such other brokers to participate in the commission generated from execution, in the over-the-counter market or on regional exchanges, of orders which the institutional broker has received from other customers.

3 Securities and Exchange Commission, "In the Matter of the Commission Rate Structure of Registered National Securities Exchanges", SEC File No. 4-144 (1968-71).

4 SEC, "Institutional Investor Study Report", H.R. Doc. No. 92-64, 92nd Cong., 1st Sess. (1971).

ships between, on the one hand, institutions (particularly mutual fund managers and banks) and, on the other, broker-dealers. This has had the effect of making commission rates for institutions negotiable but limiting the extent to which the ultimate investor rather than the money manager has benefited from such negotiation . . . These relationships tend to aggravate potential conflicts of interest. . . ."

In April 1971, at the direction of the SEC, American exchanges provided that commissions on the portion of exchange orders involving $500,000 or more were to be competitively determined.

The "Market Structure Statement",[5] issued on February 2, 1972, by the SEC, concluded that a reduction to $300,000 was called for in the breakpoint above which commission rates on exchange transactions should be competitively determined. In response to the SEC's conclusions, the breakpoint on fixed commission rate schedules was lowered to $300,000 in April 1972.

Finally, in its Release No. 10383 (Sept. 11, 1973), the SEC indicated that it would act promptly to terminate the fixing of commission rates after April 30, 1975, if the exchanges did not, on their own initiative, adopt rule changes achieving that result.

One of the major reasons underlying that decision by the SEC was that, for institutional investors, the commission rates were in fact negotiated. The numerous interventions of the SEC and to a lesser extent of the exchanges to abolish the customer-directed give-ups and the reciprocal business practices were unsuccessful. In fact, institutions and the brokerage community were able to split minimum commission by devices which achieved the same results as "give-ups", such as "mirror transactions"; the "step-outs", the "four-way tickets"; the "eight-way tickets"[6] and all kinds of soft-dollar deals.

The history of the Canadian securities markets parallels that of the United States markets. The Canadian securities commissions and self-regulatory bodies have followed with great interest the evolution of this situation in the United States. This is to be expected because the Canadian and United States economic systems are so closely linked.

If we consider, for instance, the commission rate structure in Canada and in the United States, the similarity is remarkable. In fact, one of the arguments often used by the Canadian exchanges in requesting changes in commission rates was their comparison with the rates on United States exchanges (mainly the NYSE). The purpose of those comparisons was to show that the Canadian exchanges should be able to compete with the United States exchanges with respect to commission rates in order to prevent "the movement of sizeable portions of trading

5 SEC, "Statement on the Future Structure of the Securities Market", 37 Fed. Reg. 5286 (March 14, 1972).

6 Securities Industry Study, "Report of the Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce", H.R. Doc. No. 92-1519, 92nd Cong., 2d Session, at 133 (1972).

in interlisted issues of the United States (since) such an event would be injurious to the liquidity of the Canadian markets".[6a]

That relation between the two countries is made evident by the dates on which the recent changes in commission rates took place:

New York Stock Exchange	*Montreal Stock Exchange*
September 25, 1973	November 28, 1973
November 19, 1974	November 19, 1974
May 1, 1975	
	January 1, 1976

Furthermore, it seemed important to point out certain features of the commission rate schedules and the evolution of those schedules in Canada and the United States.

1. COMMISSION RATES ARE A FUNCTION OF THE TOTAL AMOUNT OF THE TRANSACTION AND OF THE PRICE PER SHARE

Table II-1
Commission Rates in Canada Since January 1, 1976

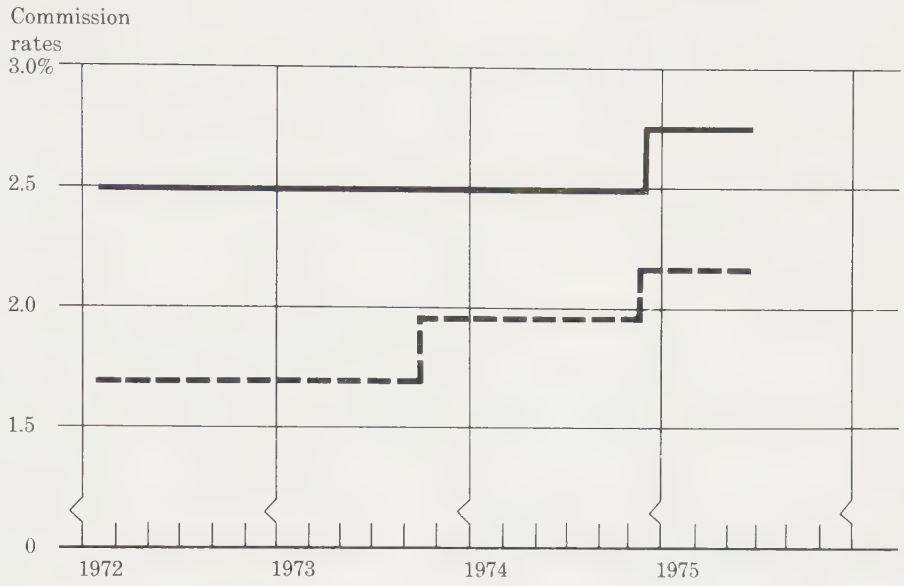
Total amount of the transaction	Rate of commission on shares of		Spread ((a-b)/a)
(000's)	$10 (a)	$30 (b)	
10	2.50%	1.64%	34%
30	2.25	1.48	34
50	1.95	1.28	34
100	1.40	0.92	34
150	1.18	0.78	34
200	1.08	0.71	32
300	0.97	0.63	35

a According to the total amount of the transaction:
Table II-1 shows that since January 1976, if the price per share is $10, the commission rate on a $10,000 transaction is 2.5% and it is 1.40% on a $100,000 transaction. Likewise, if the price per share is $30, the commission rate on a $10,000 transaction is 1.64% and it is 0.92% on a $100,000 transaction. Thus, there is a spread of 44% in both cases.

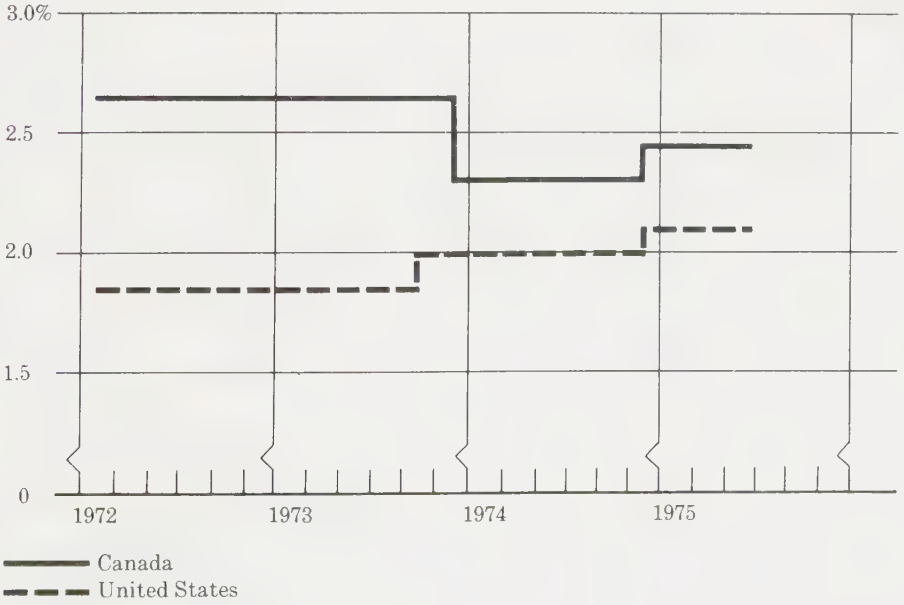
b According to the price per share:
From the same table one can see that on a $10,000 transaction, the commission rate is 2.5% on a $10 stock, and it is 1.64% on a $30 stock. Likewise, on a $100,000 transaction, the commission rate is 1.40% if the price per share is $10 and 0.92% if the price per share is $30. In both cases there is a 34% spread.

6a MSE, "Presentation of the Proposed Commission Rates to the Members of the Montreal and Canadian Stock Exchanges", April 27, 1972, p. 17. A similar argument has also been invoked at the OSC hearings on commission rates October 30 and 31, 1974).

Graph II-2
Changes in the commission rates in Canada and the United States from March 1972 to April 1975 on a 1,000 share transaction in a $10 Stock ($10,000)



Graph II-3
Changes in the commission rates in Canada and the United States from March 1972 to April 1975 on a 10,000 share transaction in a $10 Stock ($100,000)



The above remarks suggest that it is less expensive for a client, to make a $30,000 trade in a $30 stock than in a $10 stock. We don't see how this could be justified since it is probably not much more costly for a brokerage firm to execute an order of 1,000 shares at $30 than an order of 3,000 shares at $10.

2. GENERALLY SPEAKING, BETWEEN FEBRUARY 1972 AND APRIL 1975, THE SPREAD BETWEEN THE CANADIAN AND UNITED STATES COMMISSION RATES HAS BEEN REDUCED .

Graphs II-2 and II-3 show that, on a transaction totalling $10,000 in a $10 stock, the spread went from 45% in April 1972 to 29% in April 1975. On a $100,000 trade in a $10 stock, the spread went down from 82% to 29% during the same period.

3. IN APRIL 1975, WHEN THE AMOUNT OF THE TRANSACTION WENT UP, THE SPREAD BETWEEN CANADIAN AND UNITED STATES COMMISSION RATES INCREASED, THEN DECREASED TO ZERO AND INCREASED IN THE OPPOSITE DIRECTION

Graphs II-4 and II-5 show that for a $10 stock, the spread was 28% on a $10,000 transaction, 54% on a $50,000 transaction and 0% on a $300,000 transaction (*i.e.*, the United States and Canadian rates were equal). For a $30 stock, the spread was 15% on a $10,000 transaction, 32% on a $50,000 transaction and −4% on a $300,000 transaction.

4. IN JANUARY 1976, THE SPREAD INCREASED BETWEEN CANADIAN AND UNITED STATES COMMISSION RATES IN THE CASE OF INSTITUTIONAL TRADING ONLY

To reach that conclusion, we had to make different hypotheses, since no one knows the exact average rate structure at the New York Stock Exchange. These hypotheses were based on the following facts:

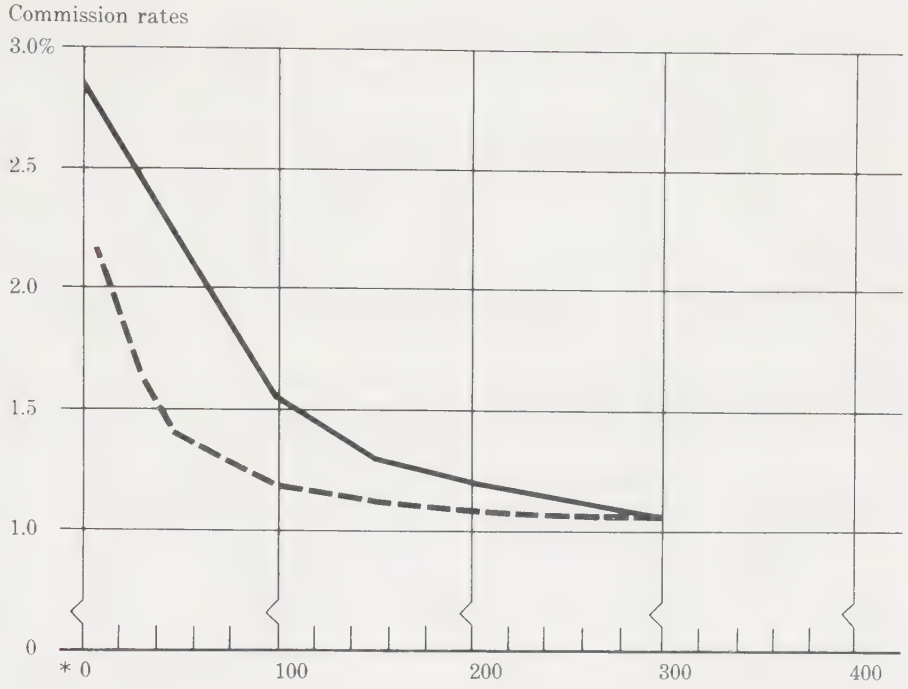
a) The average price per share traded at the NYSE by institutions was $31.38 on August 31, 1975.[7]

b) The average size of institutional (and intermediaries) orders were[8]
205 shares in 1961
644 shares in 1969
713 shares in 1971.

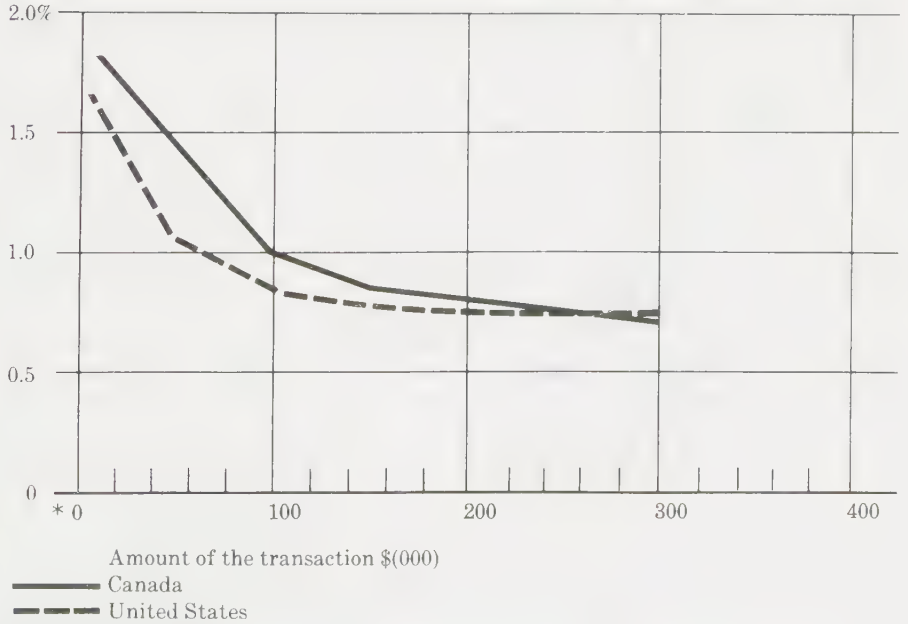
7 SEC, "Report to Congress on the Effect of the Absence of Fixed Rates of Commissions", December 1, 1975, p. II-4.

8 NYSE Research Department, "Public Transaction Study", New York Stock Exchange, Inc., April 1972, p. 16.

Graph II-4
Changes in the commission rates in Canada and the United States on a $10 stock as per the amount of the transaction in April 1975



Graph II-5
Changes in the commission rates in Canada and the United States on a $30 stock as per the amount of the transaction in April 1975



c) About 74% of all transactions at the NYSE in 1974 were made in blocks of 200 to 9,999 shares[9]
(*i.e.*, 200–999 shares: 36%
1,000–9,999 shares: 38%).
and the average shares per tape print was 438.[10]

d) From May 1, to December 31, 1975, the commission rates at the NYSE for institutions decreased by[11]
23% on transactions of 200 to 999 shares
31% on transactions of 1,000 to 9,999 shares
32% on transactions of 10,000 or more shares
30% on all institutional trades.

Taking these facts into account, we have made the following hypotheses for institutional transactions:

a) An average price per share of $30
b) An average order of 1,000 shares
c) Commission rates reduced by the following percentages:

Amount of the transaction (000's)	Reduction as a percent of commission rates in effect in April 1975
$ 10	20%
30	29
50	30
100	30
150	30
200	30
300	30

d) The above percentages of reduction also apply to the commission rates on $10 shares.

Given the acceptance of those hypotheses, we find out from Graphs II-6 and II-7 that, in the case of shares at $10, the spread between Canadian and United States rates was

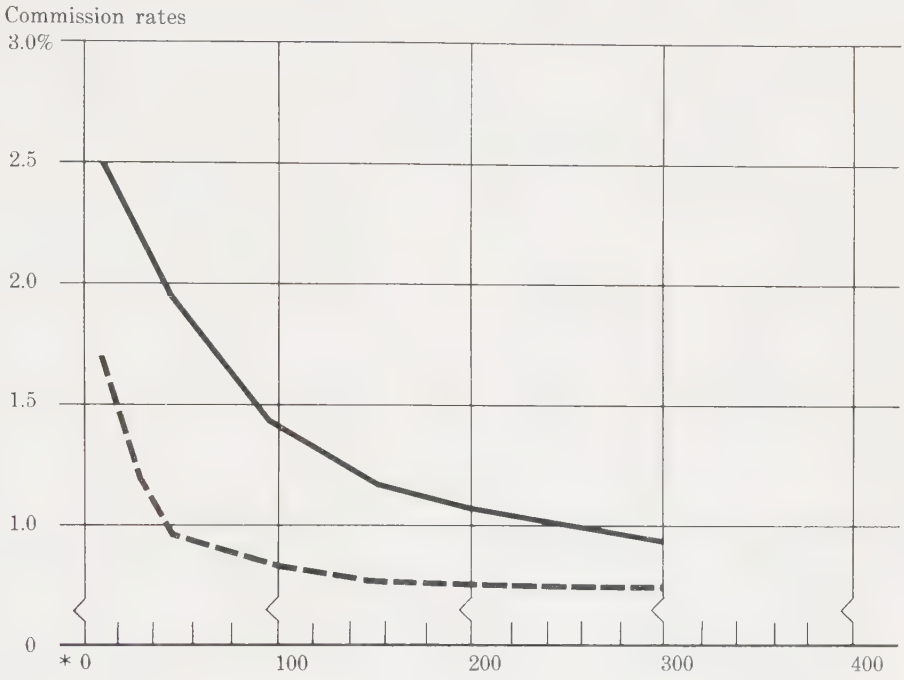
46% on a $ 10,000 trade
99% on a $ 50,000 trade
31% on a $300,000 trade.

Likewise in the case of shares at $30, the spread was

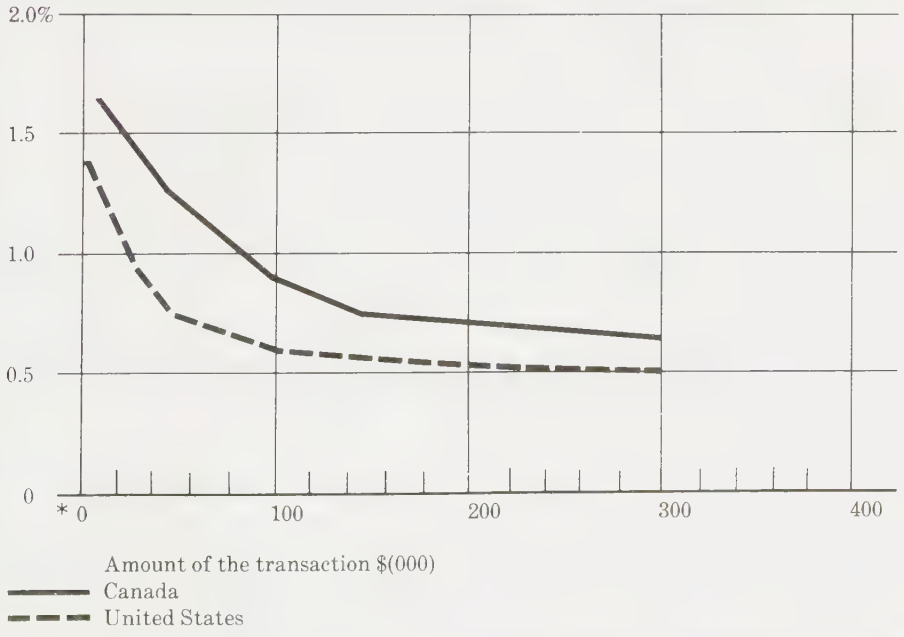
25% on a $ 10,000 trade
57% on a $ 50,000 trade
24% on a $300,000 trade.

9 NYSE, "1975 Fact Book", pp. 10–12.
10 *Ibid.* p. 11.
11 SEC, "Second Report to Congress on the Effect of the Absence of Fixed Rates of Commissions", March 29, 1976, Exhibits 4 and 5.

Graph II-6
Changes in the commission rates in Canada and the United States on a $10 stock as per the amount of the transaction in January 1976



Graph II-7
Changes in the commission rates in Canada and the United States on a $30 stock as per the amount of the transaction in January 1976



Thus, even after the elimination of the 10% surcharge in Canada, the spread increased between Canadian and United States rates. Table II-8 summarizes characteristics 3 and 4 above.

Table II-8
Spreads Between Canadian and United States Commission Rates in April 1975 and in January 1976

Price per share	Amount of the transaction (000's)	Spread as a percentage of the United States rate	
		April 1975	January 1976
$10	$ 10	28%	46%
10	50	54	99
10	300	0	31
30	10	15	25
30	50	32	57
30	300	−4	24

These spreads between Canadian and United States commission rates are theoretical since they are based on hypotheses and also because they do not take into account the soft dollar deals between certain brokers and clients.

We don't know to what extent these practices have diminished in the United States since May 1, 1975. However, we know that they are wide-spread in Canada.

These practices take many forms and the MSE classified them in two categories:[12]

a "low grade type of abuses": junkets, payment of subscription to business magazines or newspapers, rental of equipment or facilities, etc. . . .

b "sophisticated services": those which are considered by some as a normal extension of brokerage research facilities.

Whatever the category, these practices are nothing but a rebate on commissions for which the amount varies along with the institutions and the broker-dealers. In one case we have estimated the amount of soft dollars received by one institution in 1975 to approximately 10% of the yearly commissions paid by that institution.

Thus, agreements between broker-dealers and institutions do exist and are negotiated in order to establish the price that the institution will pay for the services it receives.

12 Letter from the President of the Montreal Stock Exchange, January 29, 1975.

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